

Compensating the "Prudent Man"
An Examination of the Trend Towards Performance Based Fee Structures
in the Pension Real Estate Advisory Industry

by
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Abstract

The traditional compensation arrangement and appraisal process that outlined the relationship between pension plans and real estate advisory firms during the 1980's has been replaced with performance based fee structures to reduce potential conflicts of interest, enhance accountability and increase performance returns. Historically, the primary compensation to the pension advisor has been the yearly asset management fee, based on the periodic appraisal of the real estate portfolio. Since the advisor usually controls the appraisal process, many believe there is an inherent conflict of interest to generate a high appraisal value and hence a high asset management fee. Under this type of fee arrangement, there is an incentive to grow assets under management rather than to grow the returns of those assets.

In response to these complaints, most advisors have recently restructured their fee arrangements in order to better align their interests with those of the plan sponsors. To that end, advisors developed several different types of performance fee structures based on the absolute performance of their portfolios. However, this trend towards performance based fees has been met with lengthy legal debate over whether these performance fee structures are permissible under current ERISA guidelines. The DOL is concerned that under certain performance fee structures an advisor, acting as a fiduciary, may violate section 406 of ERISA, if the advisor uses any of the authority, control, or responsibility that makes him a fiduciary to effect the timing or amount of his fee. Consequently, the DOL's interpretation of ERISA's “Prudent Man” rule and the prohibited transaction rules are the only real impediments to the continued trend towards performance based fees in the pension advisory community.

Despite the current enthusiasm for performance based fees, they are not without their own problems and improper incentives. However, most of these problems can be averted by plan sponsors closely monitoring the activities of the advisors and carefully developing, in conjunction with the advisors, a fee structure that creates the appropriate incentives and closely aligns both parties' interests.

Thesis Supervisor: William C. Wheaton
Title: Professor of Economics

Acknowledgments

This thesis is dedicated to Allison, for her love, support and sacrifices during this disruptive year, and to my parents who have always made great things possible.

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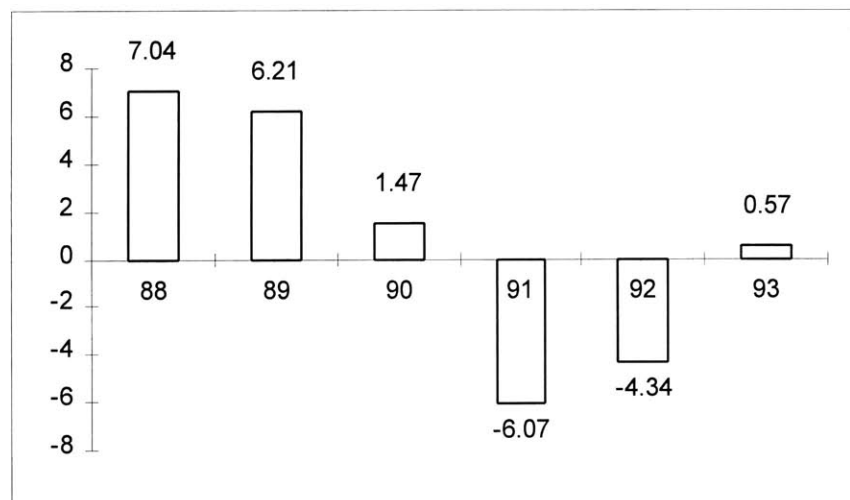
Chapter One

An Historical Overview of the Pension Advisory Compensation Issue

Overview

During the early 1990's, both public and private pension funds took enormous hits to their bottom lines in the form of large write downs, negative value adjustments as well as low or negative returns in their real estate investment portfolios. Many of the real estate assets held in these portfolios were purchased for top dollar in the real estate boom of the 1980's. Trophy office towers were bought for over \$400 per square foot in many cities and regional malls were trading at 5% capitalization rates throughout the United States¹. Most of these properties were subject to huge negative value adjustments and created a state of panic as many pension funds saw their portfolios drastically decline in value virtually overnight.

Exhibit I
Russell-NCREIF Index
Property Returns



Source: Russell-NCREIF Property Index

¹ Ori, J. "Pension Plans and Real Estate Sponsors: Forging New Relationships", *Pension World*, July, 1993

Few would argue that the major culprit of the real estate crash was the easy availability of capital in the 1980's. Debt and equity capital was readily available from banks, pension funds, savings and loans, insurance companies, credit companies and foreign investors (primarily the Japanese). The easy availability of capital increased the value of real estate assets to unprecedented levels. During the early 1990's these values were corrected and devalued to more realistic levels.

In reaction to these low real estate returns, pension funds began reviewing their relationship with pension advisory firms. While advisory firms continue to lend their expertise and provide an invaluable service to the pension funds, many funds over the last few years have taken this opportunity to restructure the traditional advisory compensation arrangement and relationship as a means to better align their interests and ultimately enhance real estate performance in the latter part of this decade and in to the next century.

Traditional Compensation Arrangement

In order to fully understand the intricacies of this new relationship, it is necessary to first examine the traditional compensation arrangement and appraisal process that outlined the relationship between pension plans and real estate advisory firms during the 1980's. Historically, pension advisors developed large commingled investment funds structured as group trusts with equity investments from a number of pension funds. Typically, these trusts bought high quality real estate and the entire portfolio would be managed by the pension advisor. While there are numerous fee arrangements, generally the advisory firm would receive an up-front property acquisition fee equal to .5% to 2% of the value of the property acquired, annual property management fees of 4% to 6% of gross property income and an asset management fee of .5% to 2% of the annual valuation of the real estate portfolio². Clearly, the majority of the advisor's fee came from the annual asset management fee. In fact, it was not uncommon for a large pension advisor with \$4 billion under management to earn yearly asset management fees of \$20 million to \$80 million.³

² Burke, T. "The Role of Investment Advisors", *Pension World*, June, 1993

³ Ori, p.20

Since the real estate investment made to these commingled funds during the 1980's was generally non-discretionary in nature, the advisor usually made all management, leasing, cash flow distribution, re-financing and disposition decisions. In addition, the pension advisor was also responsible for arranging the periodic (annual or semi-annual) appraisal of the real estate portfolio through independent appraisal firms. This valuation estimate was then used as a measure to pay the yearly asset management fee. During the 1980's, when real estate values were soaring, this process worked well and there were few complaints from either side. It was profitable for the pension advisory firms and because the advisor was responsible for almost all decisions, it relieved the pension fund of all day-to-day responsibilities. This was increasingly important as most staffs at the pension funds were relatively small and typically had little, if any, real estate experience.

Trend Toward Direct Investment

As will be discussed in the following chapter, the inability of many pension funds to liquidate their interests in commingled funds during the real estate crash of the 1980's, caused many pension plans to begin to bypass commingled funds for discretionary special account arrangements and direct investments through their own real estate departments. In fact, the illiquid nature of commingled real estate investment continues to haunt the industry as evidenced by two recent widely publicized law suits against Aetna Life and Casualty Company and the Prudential Insurance Company regarding the overvaluation of their real estate portfolios.⁴ This trend toward direct investment has reduced the importance of the advisory firms and gives the pension plans more control, flexibility and in many cases more liquidity. Many pension plans argue that this new investment structure also provides the plans with more responsibility, and therefore more accountability to plan beneficiaries.

⁴ Johnson, K. "Aetna is Accused of Hiding Potential Real Estate Loses" *The New York Times*, May 16, 1995

Wrong Incentives?

These recent developments have caused many real estate experts to argue that the traditional compensation arrangement and appraisal process is long overdue for a complete restructuring in order to reduce potential conflicts of interests, increase accountability and increase the performance of their real estate portfolios. As previously discussed, the primary compensation to the pension advisor has been the yearly asset management fee, based on the periodic appraisal of the real estate portfolio. Since the advisor usually controls the appraisal process, many critics argue that there is an inherent conflict of interest to generate a high appraisal value and hence a high asset management fee. Some feel that under this type of fee arrangement, there is no direct incentive for the advisor to maximize real estate values that may only be realized upon the disposition of the property.

The asset-based fee structure evolved from stock and fixed income compensation programs. Historically, money managers on Wall Street have received annual asset management fees based on the value of assets under management. This compensation arrangement is ideal for the stock and bond markets because of the real time pricing and liquidity of the market. Real estate, however, is a much more complex, illiquid and management intensive investment.

While real estate is a long term investment, investment managers should always strive to buy low and sell high. The key to success in real estate investment is obviously to buy during the bust market and sell during the boom market. Unfortunately, in real estate that can become very complicated and dangerous to investment managers. Oftentimes, the disposition of a property can take up to and often over a year and even if the returns on the investment for the pension plan are attractive there is no guarantee that the money will be reinvested with that firm. Since the majority of the advisors fees come from assets under management, their profits stand to be trimmed substantially.

In addition, some argue that there may also be a bias in the type of properties purchased in this arrangement. If the compensation structure is based on the appraised value of assets under management wouldn't the advisor tend to purchase high quality and

high priced office towers in CBD's as opposed to management intensive smaller properties. While it may take the same amount of man-hours to manage a \$10 million office building as a \$100 million office tower, the yearly asset management fees can differ as much as \$3 million depending on the acquisition and management fee structure⁵.

The Appraisal Process

The other area of potential conflict is the appraisal system itself. As previously discussed, the appraisal process is controlled by the pension advisor. With yearly asset management fees based on the value of the appraisal, some feel there is an inherent conflict of interest to inflate values in order to increase yearly asset management fees. Another problem stemming from this apparent conflict of interest is the pension fund's inability to recognize downward trends in the market. Additionally, this may only add to the hesitancy of many pension plans to write down the value of their accounts, as was the case in the late 1980's and early 1990's. The issue becomes the pension account's senior managements' inability to track trends, which impairs their ability to make educated investment decisions regarding their real estate portfolios.⁶

Trend Towards Performance Based Fees

As a response to these criticisms, many advisors in recent years have restructured their fee arrangements in order to better align their interests with those of the pension plans. To that end, they have developed several different types of performance based compensation arrangements. These performance based fee arrangements are a well established and rapidly expanding method of compensating institutional real estate investment managers and advisors. When properly structured they align the interests with investor more closely than asset-based fee arrangements. Many feel that it provides an added degree of assurance for investors that investment managers will be focused on achieving the investment results being sought by the pension plans.

⁵ Ori, p.21

⁶ Ibid.

“Performance” versus “Incentive”

It is important to note that this thesis uses the term “performance fee” rather than “incentive fee” in recognition of the fact that many fee structures provide investment advisors with fee incentives that are not necessarily related to performance. For instance, a fee based on a fixed percentage of assets under management may provide an advisor with an incentive to invest the assets as soon as possible. This incentive is particularly strong where, as is common, the investment manager has no assurance that if he disposes of an asset he will be authorized to reinvest the proceeds.

However, a fee structure that bases the fee on original cost, where the advisor anticipates that he will be authorized to reinvest the proceeds, may give the manager an incentive to maximize current cash flow regardless of the effect on long term value. Fees that are based on gross asset value may provide managers with the incentive to leverage the managed assets. Fees based on net asset value may provide managers with an incentive to acquire properties as quickly as possible on a non-leveraged basis. Disposition fees, including performance fees for which payment is triggered by disposition, may provide an incentive to dispose of the property. Of course in this instance, the incentive may be offset by the incentive to hold arising from an ongoing asset-management fee.⁷ Therefore, the term “performance fee” is used to describe any fee structure under which the investment advisor’s fees vary according to the performance of the portfolio, other than on the basis of a fixed percentage of assets under management.

Compliance with ERISA

This trend towards performance based fee structures has been met with lengthy legal debate over whether these performance fee structures are permissible under current ERISA guidelines. As will be discussed in great detail in chapter three, the Department of Labor (DOL) has, through their enforcement of the ERISA guidelines, suggested that performance based fee structures must not violate either the “prudent man” or prohibited

⁷ Krueger, H. “Reconciling Performance Fees For Pension Fund Real Estate Managers With ERISA”, *Real Estate Review*, 1991

transaction rules of ERISA.⁸ The DOL is concerned that under some performance fee structures an advisor, acting as a fiduciary, may violate section 406 of ERISA, if the advisor uses any of the authority, control, or responsibility that makes him a fiduciary to effect the timing or amount of his fee.⁹ Consequently, there is a great deal of uncertainty about whether the use of performance based fee arrangements are viewed as permissible by the DOL.

Conclusion

The objective of this thesis, as outlined in this chapter, is to examine the current trend in the industry to create a new real estate structure which better aligns the pension plans interests with those of the investment advisors. In order to frame the subject in an historical context, chapter two will provide an historical overview of pension fund investment in real estate and the pension advisory industry, as well as the evolution of their compensation arrangements. Chapter three will provide a comprehensive study of the ERISA guidelines as a means to provide a legal framework for the issues regarding performance based fees. In an attempt to determine what , if any, are the industry standards regarding advisors fee structures, chapter four will present the results of a comprehensive survey of over 50 real estate investment advisors fee structures. Chapter five dissects and then discusses the basic issues and components of performance based fee structures, while chapter six presents a summary of the findings of this thesis.

⁸ Ibid.

⁹ Ibid.

Chapter Two

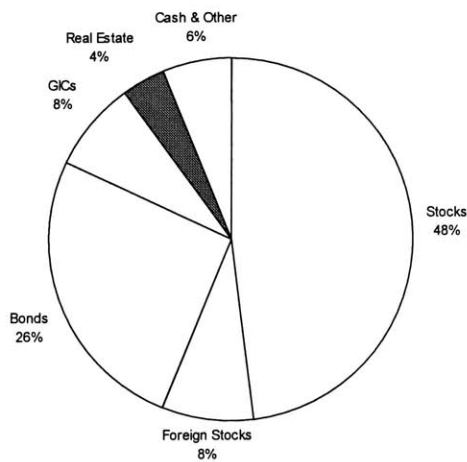
An Historical Overview of Pension Fund Investment in Real Estate, the Pension Advisory Industry and Compensation Arrangements

Overview

This chapter provides an historical overview of pension fund investment in real estate, examining the underlying economic and regulatory forces which influenced pension funds acceptance of real estate as a core portfolio asset. While pension funds' use of real estate will be profiled in this chapter, the discussion will also include an historical overview of the pension advisory industry itself, as well as the evolution of compensation arrangements between advisors and plan sponsors.

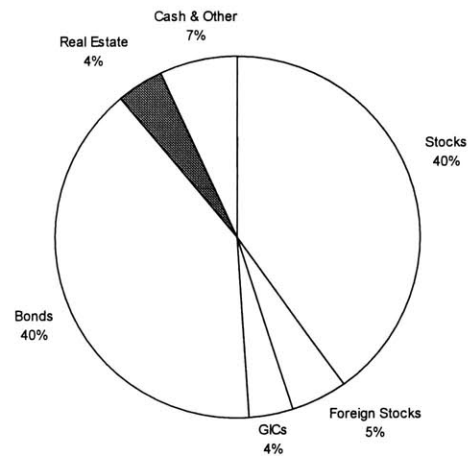
Exhibit II

Pension Fund Asset Allocation



Public

Source: Paramount Capital Corporation



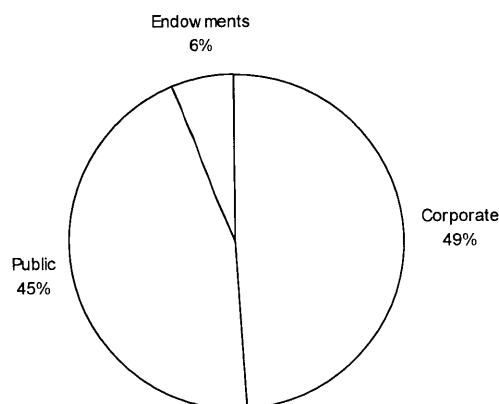
Corporate

It is currently estimated that public and private pension funds have total assets of approximately \$2.4 trillion, which constitutes the largest single pool of capital in the United States.¹ This figure represents a 150% increase over the 1980 level of

¹ Flow of Funds Account, Board of Governors of the Federal Reserve System

approximately \$916 billion and is considered to be the fastest growing source of real estate capital.² If 10% of these assets were invested in real estate, it would represent \$240 billion in investable funds. While the current allocation falls short of this mark, estimated at 4% to 4.5% of the total, this still represents almost \$100 billion invested in real estate equities and mortgages (see exhibit II).³ However, this average disguises a wide range of levels of investments by individual plans. For instance, it is believed that small plans remain close 0%, while many of the larger funds have invested in the 10% to 15% range.⁴ Of the estimated \$100 billion invested by pension plans in real estate equities and mortgages, it is believed to be almost evenly split between public and private plans. Corporate plans represent 49% of the institutional investment in real estate while public plans (both state and local) comprise 45%, with endowments and foundations responsible for almost 6% of the total.⁵

Exhibit III
Institutional Investment In Real Estate



Source: Greenwich Associates

² Ibid.

³ Hudson-Wilson, p.2

⁴ Ibid., p.2

⁵ Greenwich Associates, annual study of the investment management practices of U.S. tax-exempt funds, Greenwich CT, 1991

Early Real Estate Investment Vehicles

Although the first real estate commingled fund appeared in 1968 (First Wachovia Bank), it would be another 20 years before real estate would join stocks and bonds as a core portfolio asset.⁶ Real estate equity funds were first provided by bank trust departments and insurance companies, who had been the historical providers of investment opportunities for pension funds. The first investments offered were open-ended commingled real estate equity funds and were marketed toward pension funds. These funds were created to appeal to pension plans by offering a pool of diversified real estate assets that could be immediately invested in without the plan sponsors having to develop the skills necessary to invest in real estate at this level. More importantly however, these investment vehicles provided the pension plans with something very valuable to pension funds - liquidity. Liquidity was imperative because it allowed pension plans regardless of their immediate cash flow requirements, or liquidity needs, the ability to invest in what had been considered a long term investment. Or so they thought.

Despite these early funds, pension plans did not begin to seriously consider real estate as an asset allocation until the mid 1970's. Prior to the mid 1970's, pension funds were concentrated almost exclusively in stock and bond investments. In fact, prior to 1952, pension plans held little stock, preferring the safety and convenience of high grade corporate bonds for their investments.⁷ However during the 1950's, worried about the effect of inflation on pension liabilities, administrators began to shift their assets into the stock market. This trend would continue over the next twenty years. By 1972 nearly 3/4 of total pension plans assets were invested in the stock market.

Unlike the pension fund communities' increasing appetite for stocks prior to the mid 1970's, these plans avoided any major investment in real estate over this period. There were several reasons for their lack of interest in real estate, not the least of which was the fact that for most of the 1950's and 60's the stock market produced total rates of returns that equaled or surpassed expectations. Plan sponsors simply had no compelling

⁶ Menikoff, Meyer, "A Note on the Dawn of Property Investment by American Pension Funds", AREUEA Journal, Vol. 12, No. 3, 1984

⁷ McKelvey, p.14

reason to explore alternative investments, as one money manager aptly pointed out, “[During] the 60’s...any idiot who was throwing darts at the wall would make money in the stock market. So if somebody came to him and said he could make 7% in a real estate commingled fund, he’d tell him he was crazy. The manager was making 30% in the stock market.”⁸

Another problem with real estate was that its characteristics as an investment were not compatible with the overall objectives of the plan sponsors. Real estate’s lack of liquidity, market fragmentation, infrequent pricing, and inadequate information access were seen as significant barriers to entry. In addition, pension plans, as tax-exempt investors, seriously questioned whether they could successfully compete in a marketplace that so clearly favored taxable investors.⁹ These factors combined with the perception that real estate investment was far too risky for pension plans and the lack portfolio managers knowledge and experience with real estate as an asset class, led pension plans to stay on the side lines with regards to real estate investment.

ERISA and Inflation

Real estate was slowly accepted as a legitimate institutional investment for several reasons. This gradual shift represented investors response to both economic cycles and reaction to imposed regulatory measures. Namely, inflation’s negative impact on stock and bond investment performance in the early 1970’s and the congressional passage of the Employee Retirement Income Security Act (ERISA) in 1974.

With the Congressional passage of ERISA in 1974, private pension fund administrators were legally bound, as fiduciaries, to insure the performance of the fund. As will be discussed in the following chapter, the purpose of the act was to ensure that the private pension system was responsibly managed by plan sponsors. Several specific events led to the enactment of ERISA. In 1964 the Studebaker Corporation closed its doors in South Bend, Indiana. Astonishingly, of 7,200 members of the local chapter of the United Auto Workers, whose average age was 54, only 1,100 were eligible for a

⁸ Ibid., p.18

⁹ Hudson-Wilson, p.2

pension. This was because the pension plan was not scheduled to be fully funded until the year 1989. Thousands were left unemployed and stripped of their retirement money as well. Situations such as the Studebaker plant closing prompted congress to correct the inherent flaws of the private pension system in an effort to protect the “nest eggs” of future retirees.

In establishing the standards for fiduciaries, which will be discussed in further detail in the following chapter, ERISA states “...a fiduciary shall discharge his duties with respect to a plans solely in the interests of the participants and the beneficiaries...”¹⁰ All ERISA fiduciaries are subject the “prudent man” rule, later interpreted as the “prudent expert rule”, and therefore must invest accordingly. ERISA also directs a fiduciary to “diversify the investments of the plan so as to minimize the risks of large losses, unless under the circumstances it is clearly prudent not to do so”¹¹. However, it is important to note that ERISA made no attempt to specifically define “diversify the investments”¹².

New concepts in portfolio management were discussed in ERISA as well. The concept of “total portfolio” resulted in non-traditional asset classes such as real estate equities, to be considered as prudent pension fund investment alternatives to the more traditional stocks and bonds.¹³ ERISA resulted in dramatic changes in the composition of institutional investment portfolios. During the 1970’s, real estate emerged as the undisputed leader of non-traditional asset classes to be included in any meaningful amount to the pension funds investment portfolio.

The prudence regulations and the clause governing investment policies, which will be discussed in further detail in chapter three, did not specifically instruct a manager how to invest. In fact, many argue that these regulations gave rise to the allegation that pension funds operate under a “herd” mentality. In other words, if the majority of funds are invested in equities, for example, it must be prudent to do so.¹⁴ Unsure of how the new law would subsequently be interpreted in court, pension funds invested in

¹⁰ Section 404 of ERISA

¹¹ Ibid.

¹² Hudson-Wilson, p.9

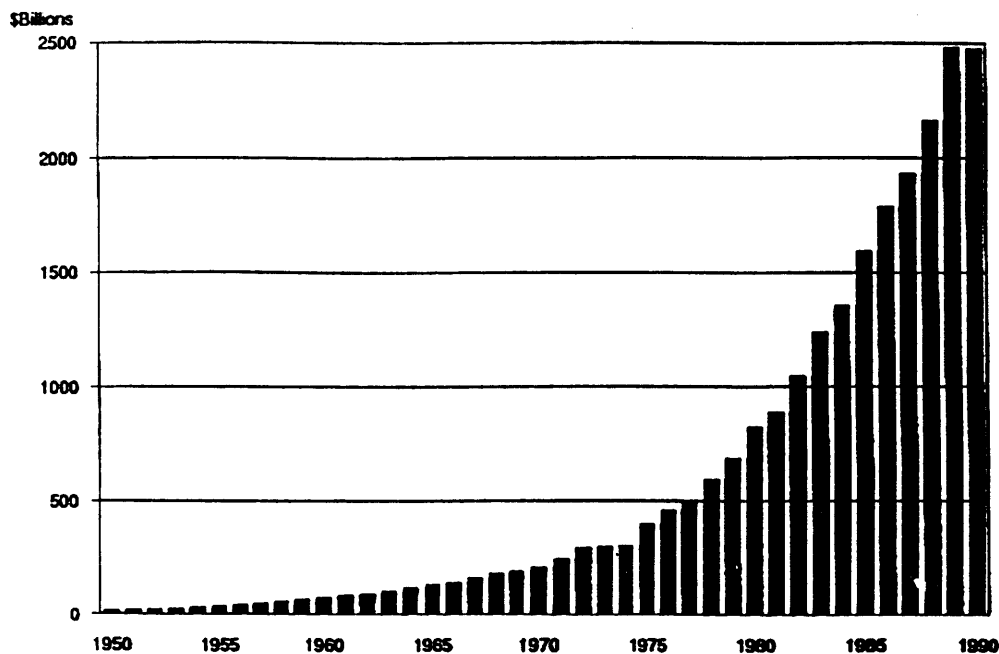
¹³ Ibid.

¹⁴ Brown, Ellen “The Evolution of Pension Fund Investment in Real Estate”, masters thesis, MIT Center for Real Estate, 1990

conservative, “prudent” investments. However, the Department of Labor (DOL), later clarified that the “prudence” rule did not rule out risky or investments in non-traditional assets. Furthermore, the DOL went on to state that non-traditional investments could “improve diversification” if it included new investment opportunities in such areas as small businesses and real estate.¹⁵

Motivated by ERISA, pension plans were in need of new forms of investments in which to invest their ever-growing pool of funds. This growth in assets, which needed to be invested, coincided with an expanding economy and an increase in the demand for space from businesses. Fortunately this vast amount of capital could be absorbed in the United States real estate market because it was large enough not to be dominated by any one fund.

Exhibit IV
Total Pension Fund Financial Assets
and Rate of Growth 1950-1990



Source: Employee Benefit Research Institute

¹⁵ ERISA Committee Reports, par. 5035

In conjunction with timing of the passage of ERISA, the inflation of the 1960's and 1970's revealed that a large commitment to stocks and bonds automatically exposed the portfolio to the impact of high rates of unanticipated inflation. Certainly this situation was not in the best interests of plan beneficiaries and plan sponsors. Consequently, portfolio managers recognized the need to further diversify the portfolio in an effort to reduce the overall risk of the portfolio.¹⁶

Academic Approval

While these two events clearly were instrumental in real estate's acceptance as an institutional investment there were two other factors that contributed to the perceived advantage of pursuing alternative investments to stocks and bonds. Both factors emerged from work in academia.

First, it was widely realized that real estate, as an asset class represented the largest single store of wealth in the world. Investors seeking a "market portfolio" of investable assets, should therefore hold some component of real estate. Secondly, the acceptance of modern portfolio theory (MPT) in managing total portfolio risk. Ibbotson and Siegal stated that real estate could improve the risk adjusted portfolio in one of two ways. First, market inefficiencies could be taken advantage of to produce a "good buy". Secondly, the addition of real estate as an asset class may reduce overall portfolio risk, even if it is not a "good buy".¹⁷ Additionally, Bruggeman, Chen and Thibodeau published the results of a study which pointed to the diversification benefits derived from real estate, demonstrating that it was negatively correlated to stocks and bonds. Furthermore, the study showed that real estate provided an excellent hedge against inflation.¹⁸ Real estate began to be seen by portfolio managers as an excellent diversification strategy.

¹⁶ Hudson-Wilson, p.4

¹⁷ Ibbotson and Siegal, "Real Estate Investment Funds: Performance and Portfolio Considerations", AREUEA Journal, Vol. 12, No.3, 1984

¹⁸ Ibid.

Market Goes Up

Another factor in the growth of pension fund investment in real estate was the real estate market itself. The real estate boom, which was generated by the strong demand from the economic market of the late 1960's, had peaked by the 1970's with the onset of the 1973 recession. With interest rates and construction costs at historic highs, demand for space evaporated. The combination of high vacancy rates and lack of any new construction led to the collapse of the fledgling REIT industry which resulted in more distressed properties hitting the market.¹⁹ From 1974 to 1976 both buildings and land were selling discounted prices and commingled funds were able to purchase these properties for much less than replacement cost. When the real estate market began to tighten by 1977 and inflation began to rise towards double-digit levels, these commingled funds were able to post returns that far outperformed the equity and bond markets.²⁰ These factors combined with the geometric increase of investable contributions to pension funds led pension funds to seriously consider real estate as an asset allocation.

1980 was a threshold year for real estate. *Pension & Investments* annual survey of the pension fund community found that 22% of the plan sponsors were invested in real estate as opposed to the 15% from the previous year.²¹ More importantly, over half of the largest funds were invested in real estate. For the most part large corporate plans, with more aggressive investment policies had led the way for pension fund investment in real estate. Public plans were quick to follow. As the first half of the 1980's came to a close, increases in the national office building vacancy rate and the additional billions of dollars chasing real estate were signs that the market was becoming overheated, despite the competitive investment returns from real estate.

¹⁹ McKelvey, p.213

²⁰ Ibid., p.213

²¹ *Pensions & Investments*, Dec. 20, 1980

Open-End Funds

The evolution of pension real estate investment vehicles began with the large, open-ended funds which were offered by insurance companies and bank trust departments. Pension funds seemed to reason that an investment with a large established insurance company surely would be considered a “prudent” investment.²² It is important to note that prior to the DOL’s clarification of the diversification clause in ERISA, there was considerable concern as to how the DOL might subsequently rule on the prudence of real estate as a responsible investment.

The presumed liquidity of these open-ended funds were perfect because if the DOL were to rule against real estate as a prudent investment, the pension funds could merely sell their shares and thereby dispose of all their real estate holdings. Another perceived advantage was that while the fund administrators were well versed in the securities markets, they knew nothing about real estate. Real estate needed a completely different set of skills to be able to invest in a prudent manner.

Closed-End Commingled Funds

Shortly after the arrival of the open-end funds, the next generation of real estate investment emerged in the form of the closed-end fund. Essentially a closed-end fund closes its doors to additional investors once the target allocation has been met. At this point, properties are purchased and held for a pre-determined period (typically 7 to 10 years). As the due date approaches, the fund is liquidated and the proceeds are distributed to the original investors, unless there are poor market conditions, in which case the fund typically has the option to wait until the properties can be sold in more favorable market conditions.

Closed-end funds are generally smaller in scope than the larger open-end funds.²³ Because of the need to diversify within a smaller amount of funds, the properties are

²² Brown, p.32

²³ Rohrer, J. “How Pension Funds are Making their Great Leap into Real Estate”, *Institutional Investor*, June 1981

generally smaller than those in the open-ended funds. For example, some of the larger open-end funds could target \$100 million properties while the closed end funds would invest in properties in the \$5-20 million range. However, other than the size differential their investment strategy was identical. Target the most prestigious, well-located properties and purchase them with 100% cash up front.²⁴

From 1979 to 1982, the number of commingled funds more than doubled from 60 to 135.²⁵ Open-ended funds led the pack both in the number of funds and the amount of money invested. However, the closed-end funds were much more innovative in their approach. The reason: The larger open-ended funds were managed by the insurance companies and the bank trust departments, while the closed-end funds were the domain of the independent advisory firms. These firms, which were more entrepreneurial by nature, set the pace for innovative thinking and shifting their investment strategies to meet market demands.²⁶

Growth of the Real Estate Advisory Industry

Due to their inexperience in real estate, few of the pension funds showed any interest in developing their own in-house real estate departments. Only the largest of the funds built their own in-house real estate departments. This proved to be a fortuitous decision for many of the independent advisory firms which came into existence in the early part of this decade.

For the most part, growth in the real estate advisory sector mirrored that of pension fund investment in real estate. Its products and services essentially evolved in response to the growing demands of the pension funds. Clearly the passage of ERISA and exponential increase of assets needing to be placed by the pension funds spawned the growth of the advisory industry.

²⁴ McKelvey, p. 218

²⁵ Ibid., p. 211

²⁶ Brown, p.34

Prior to as late as 1980 there were approximately 15 independent advisory firms. Yet by 1981, that number had grown to as much as 40 and by 1983 the number had risen to as many as 65 independent advisory firms.²⁷

Market Goes Down

As inflation began to decline during the early 1980's, many pension funds began to shift their assets once again to the bond market in order to capture the high rates of interest. Additionally, the stock market was beginning to rebound and many investors felt it offered better value than real estate. Such reallocation strategies were a typical reaction to the changing market conditions. Portfolio managers merely realign their assets as to take advantage of any market inefficiencies, or perceived inefficiencies. Real estate was not treated any differently. Remember, real estate was sold as an inflationary hedge and clearly the expectations about inflation had changed. Many portfolio managers felt that the market was entering into a period of disinflation, so why hold real estate?²⁸

It was this reasoning that led many investors in Prudential's PRISA fund to liquidate their holdings. Unfortunately, due to the "herd" mentality of real estate other investors began to do the same as a run on the fund began to gain momentum. Although the fund had marketed itself as a "liquid" investment, investors found themselves waiting to recover their investments since Prudential declined to sell properties for below the appraised value as a means for protecting the integrity of the fund.²⁹ This well publicized event sent shock waves through the pension fund community, causing those already invested in real estate to reconsider their proportional allocation and those not yet invested to rethink the benefits of investment in real estate.

²⁷ McKelvey, p.214

²⁸ Brown, p.21

²⁹ "PRISA Sticks to its Guns in Dealing with Withdrawals", *Pension & Investments*, March 7, 1983

Trend Toward Direct Investment

By 1986 it became clear that there was a strong trend away from large open-ended funds toward specialized, closed-end funds, separate accounts or direct investments.³⁰ Increasingly, pension funds were moving away from a diversified “core” portfolio approach to more specialized investing which would enhance overall portfolio returns.

Exhibit V Changing Commingled Fund Characteristics

	<u>1983</u>	<u>1988</u>
Open-End Funds	80%	62%
Closed-End Funds	20%	38%
Diversified	87%	76%
Specialized	13%	24%

Many of the large pension funds began investing in real estate directly, either through separate accounts managed by advisory firms or through their own real estate departments. There were several reasons for this gradual shift.³¹

For one, direct investment was viewed as a natural progression for many of these funds. Since many of the larger funds had been involved in real estate investments from the 1970's, they felt more comfortable with real estate as a valid asset class. Having worked their way along the learning curve they felt they could finally take a more active role in the decision making process.

Secondly, many of the fund managers felt that by having more direct control over an asset, there would be a greater chance of higher returns. They felt they would have more financial flexibility to take advantage of market inefficiencies and would be able to design their investments to more closely align their needs with the real estate investment.

³⁰ Hemmerick, S. “Investors Place \$5.6 Billion of New Business in Direct Accounts”

³¹ Rohrer, J. “Real Estate Managers Tough It Out”, *Institutional Investor*, June 1983

The third, and perhaps the most significant reason for the shift away from commingled funds, was the general dislike of the entire commingled fund structure itself. As previously discussed, the open ended-funds certainly were not as liquid as originally thought and there were beginning to be complaints about the valuation process when an investor wanted to leave a fund. All entering and exiting share values were based on the appraised value, not the market value, and there was widespread skepticism regarding the appraisal process across the pension fund community. Many felt there was an inherent conflict of interest since the asset management fee structure was linked to the appraised value.

Between 1983 and 1988, the percentage of pension funds using direct separate accounts increased from 33.3% to 62.5%.³² For the first time the fee structure of many of the commingled funds were being challenged, as was the process for using appraisals for determining fund valuation. With this trend toward separate accounts, pension funds were in a better position to negotiate fees with the advisory firms. It was at this point that the traditional asset-based fee structure began to be replaced with lower base fees and performance based fees.

Exhibit VI
Direct vs. Commingled Real Estate Investments

	<u>1983</u>	<u>1988</u>
Direct	33%	62.5%
Commingled	67%	37.5%

Modified Fee Structures

Heitman Advisory in Chicago, was one of the first firms to use a modified fee structure.³³ In fact, it could be argued that their sliding fee scale was one of the reasons Heitman became the largest real estate manager in 1987 with over \$3.6 billion under management. Their system worked as follows: For the first \$10 million invested, a 4% fee was charged, 3% for the next \$10 million and 2% on the next \$20 million invested,

³² From *Pension & Investments* annual survey of advisory firms

³³ *Institutional Investor*, October, 1987

and a 1% fee when the total value of the assets exceeded \$40 million. A 2% disposition fee was charged for the first \$10 million returned to the client, 1.5% for the next \$10 million and 1% for any amount over \$20 million. An annual fee of 25 basis points multiplied by the original amount of the cash invested was charged, as well as 5% of the operating income which was being siphoned off for leasing and management fees.

Commingled Funds and the Appraisal Process

The debate surrounding the use of appraisals has been haunting the industry since the earliest commingled funds. However, the debate reached a boiling point in the mid-1980's when pension funds began demanding more accurate performance data in order to assess real estate's viability as an asset class. The requirement to value real estate portfolios is rooted in U.S. banking law which requires that commingled funds be valued and reported quarterly.³⁴ Under ERISA, an annual valuation must be placed on a portfolio so that plan sponsors can determine their annual contributions to the plan.

Two components essentially constitute return on real estate: cash flow from operations and appreciation of the asset. While cash flow would seem to be a fairly discernible number, discrepancies in individual bookkeeping practices can mask true returns. For example, are the numbers artificially inflated because maintenance has been deferred? Are replacement reserves included in the returns? However, these problems are by no means insurmountable. By simply standardizing accounting and operating procedures this problem can be solved quite easily. Appreciation, however, is at best an estimate.

Commingled funds are typically appraised on a quarterly basis. Annual appraisals are conducted by an outside appraiser, hired by the real estate advisor, with the intervening appraisals conducted in-house. Closed-end funds because of their longer holding periods, generally consider annual appraisals sufficient. However, quarterly appraisals were imperative to the open-ended funds, because they set going-in and going-

³⁴ McKelvey, p.218

out share values for the investors. With the exodus from these open-ended funds this valuation process came under increasing fire.

Some critics argued that this process created unfair arbitrage opportunities with these large open end funds.³⁵ Liquidations had historically been given on a first come, first serve basis, prompting many investors to “bail out”. Long term investors felt that they were at the mercy of short term investors, as these investors exited the fund whenever the market began to slide.

The main criticism of the appraisal process was that it was controlled by the advisors and not the plan sponsors. The general feeling was that since the appraiser was in the advisor’s employ, might the appraiser be persuaded to manipulate the results to favor the advisor? Appraiser impartiality became a critical question because it was so directly linked to the advisor’s fee.

When real estate began to be written down in value in the mid 1980’s, many of the pension funds wondered if the appraised value of their investment truly reflected market value. A one year lag in appraisals could represent a significant amount in fees. The writedown of the RREEF Texas properties in 1987 was a classic example of this fee debate.³⁶

One Main Place, a Dallas office tower, dropped almost \$43 million in value in the six month period between appraisals - December 1986 to June 1987. This huge decline in value was seen as proof of the inherent problem with the appraisal process. Other notorious examples include RREEF’s USA II fund which saw a \$ 21 million decline in value of a downtown Houston office tower as well as \$17 million writedown of a Denver building.

Some plan sponsors questioned why the writedowns did not come sooner. They argued that yearly appraisals lagged the market and it was suspected that appraisers were being talked into incremental writedowns so that the funds, as well as the advisor’s fees would not take so much of a big hit.³⁷

³⁵ Westerbeck, M. “Open-End Fund Drops Flag Arbitraging”, *Pensions & Investments*, March 7, 1983

³⁶ Hemmerick, “RREEF Writedown Spurs Fee Debate”, *Pension & Investments*, Sept. 10, 1987

³⁷ Ibid.

To stem the tide of discontent and bolster pension funds executives confidence in real estate investing, the National Council of Real Estate Investment Fiduciaries (NCREIF) proposed guidelines for how real estate manager's should contract with appraisers and monitor their work.³⁸ The "Guideline for Preparation of an Appraisal Engagement Letter" sought to standardize the appraisal process and procedures to be used in the appraisal process.

More Complaints About Fees

Asset management fees were also questioned. Yearly asset management fees could be substantial: \$500,000 to \$2 million on a \$100 million fund. Since the majority of the funds targeted, prime institutional properties, sponsors wondered if the management burden warranted such a high fee. How much work was necessary with a fully tenanted, top quality, CBD office building? In addition to the asset management fee, some advisors were netting as much as 5% of annual cash flow for day-to-day management for each building.

Sponsors also began to be concerned that fees were not linked to performance. Why would a manager be inclined to sell a property at the top of a market, and realize appreciated earnings if their fees are linked to the amount of assets under management? Why would a manager undertake a substantial renovation project if it would decrease operating cash flow during the construction period?

Conclusion

As a result of these complaints, more and more advisors restructured their fee arrangements in order to better align their interests with those of the plan sponsors. To that end, advisors have recently developed several different types of performance based fee structures. However, the DOL's interpretation of ERISA's "prudent man" rule and the prohibited transaction rules have continued to impede the frequency of the use of the performance based fee in the pension advisory community.

³⁸ Covalski, J. "Appraisal Guidelines Eyed", *Pensions & Investments*, March 9, 1987

Chapter Three

An Examination of the Legality of Performance Based Fees Under ERISA

Overview

Over the past five years pension plans have increasingly used performance based fee structures to compensate the advisory firms responsible for their real estate investments. In fact many governmental plans insist that their real estate management firms be compensated in relation to the performance of the investment. While there is undoubtedly a trend towards performance based fees with ERISA plans, their ratio is still smaller than compared with non-ERISA plans.

Since the investors, managers, and investment types of the non-ERISA plans are comparable to the investors, managers and investment types pursued by the ERISA plans, it appears that the reason for the difference in the frequency of the usage of the performance based fee arrangement is the complexity of ERISA law, rather than the differences in financial considerations which would affect the best interests of the plan beneficiaries.¹ Therefore, an overview of ERISA and its guiding principles is necessary in order to better understand its effect on the pension advisory fee structure.

The Employee Retirement Income Security Act (ERISA) of 1974 is the principle law governing the management and investment of private pension funds and has been called, among other things, the most complex law ever written. It is important to note that ERISA regulates only private pension plans and has no authority over public plans whatsoever. In order to better understand ERISA, it is important to know why and what congress was trying to accomplish with this law and how the Department of Labor (DOL) ultimately became involved in enforcing it.

¹ Krueger, p. 17

Why Congress Passed ERISA

As previously discussed, in 1964 the Studebaker Corporation closed its doors in South Bend Indiana. Of the 7,200 members of the local chapter of the United Auto Workers, whose average age was 54, only 1,100 were eligible for a pension due to the fact that the pension was not scheduled to be fully funded until 1989.

While there were many other pension scandals in the 1960's, the demise of the Studebaker fund was a classic example of the enormous power employers had over their pension plans in the pre-ERISA days. In that era, pension plans were creatures of the tax law and therefore the IRS was in charge of regulating them. However, the IRS was more interested in defining how a pension plan should be structured to qualify for its tax-exempt status, than how it paid and funded benefits.

The DOL had the authority to look into the administration of a plan, but only to investigate reports of criminal activity by plan sponsors or trustees, such as forgery and embezzlement. Otherwise the DOL was completely powerless to investigate a fund. The problem was that there was no state or federal agency which was responsible for regulating the day-to-day administration of the pension funds. In the pre-ERISA days a plan sponsor could underfund his plan or even terminate it if they wished; leaving the plan participants with no pension and no means of recovering their funds. In fact the plan sponsor could even allocate the plans funds for their own use, and run little risk of being detected or even held accountable.² Of course not all plans were this reckless, but a growing number were. It took congress 10 years to solve this national dilemma. Studebaker employees lost their pensions in 1964 and ERISA was not signed into law until Labor day 1974.

Instead of drafting the law from scratch, congress based it on the existing tax law. The new law set up minimum vesting and funding standards for employee benefit plans. In addition, it set forth the prudent man rule as the investment guideline for pension advisors and defined who were plan fiduciaries. ERISA required plan sponsors to provide

² Bloom, M. "Is Your Pension Safe?" *The New Republic*, Oct. 31, 1964

specific information about the status of the fund to the participants and spelled out how the plan participants could sue the plan fiduciaries if they felt the plan was being mismanaged.

Enforcement

Because both the DOL and the IRS had previously claimed jurisdiction over pension funds, congress gave it to both of them. Originally, both the DOL and the IRS jointly administered the pension industry. Not surprisingly the two agencies kept colliding into one another in their interpretation of this complex law.³ As a result President Carter, in 1979, signed an executive order, splitting the duties more specifically between the two agencies.

The sections of the law dealing with vesting, prudent investing, and prohibited transactions, among other issues, were the responsibility of the DOL. The IRS would be responsible for all the tax issues as well as enforcing prohibited transaction decisions made by the DOL, by levying taxes on guilty fund fiduciaries.

While technically the IRS and the DOL share the burden of regulating the pension community, advisors and plan sponsors involved in real estate investing typically just deal with the DOL. This is because the DOL interprets the fiduciary and prohibited transaction sections of ERISA, which have by far the largest effect on real estate decisions.

Fiduciaries

The decision whether or not to be a fiduciary under ERISA is one of the most important decisions any real estate advisor can make. Once you are deemed to be a fiduciary of your pension clients under ERISA, you become subject to a number of restraints on how you can deal with them. Immediately you become:⁴

³ McKelvey, p. 71

⁴ Ibid.

- Personally liable for the money given to you by your client to invest
- Subject to the prudent man rule and constrained as to how you can charge your client for services provided to them
- Limited in your investment decisions by ERISA's prohibited transaction rules which were designed to prevent self-dealing and conflict of interest by plan fiduciaries.

The reason for these strict guidelines is that in drafting the fiduciary language, congress wanted to ensure that if another Studebaker debacle were to occur, or if a fund was mismanaged, they would know immediately who to come after. By identifying who was responsible for the mismanagement they also identified who was responsible for coming up with the money to rectify the damage.

Therefore congress went to great lengths to define exactly who was and who was not a fiduciary. In plain English a fiduciary, under ERISA, is anyone responsible for making decisions about how a plans assets are invested and how the fund is administrated.⁵ To be a fiduciary, one must have discretionary control over the fund or part of the fund.

Types of Fiduciaries

There are two types of fiduciaries; named and delegated. Named fiduciaries are actually named in the legal documents setting up the fund. For example, a pension officer, or a member of the Board of Trustees or Board of Directors. Named fiduciaries are the only people who have the authority to delegate legal responsibility for the plan. However, a named fiduciary can relieve themselves of almost their entire fiduciary responsibility by hiring investment advisors, as defined by ERISA, and delegating the investment responsibility to them. The investment advisor then becomes a delegated fiduciary and is responsible for only the assets he manages.

⁵ Ibid.

As long as the named fiduciary uses “prudence” in hiring the delegated fiduciary and carefully monitors their performance, they are not responsible for the action of the investment advisor.⁶ While the named fiduciary is still ultimately responsible, there is now a layer of protection for the named fiduciary. Congress did not want to burden the named fiduciaries with the responsibility of selecting an investment advisor on their own, so they provided guidance in this area. If the named fiduciaries hires an investment advisor who is a plan asset manager as qualified in section 3(38) of ERISA, they would be deemed as having appointed a delegated fiduciary and would be free of all the responsibility of that advisors investment decisions.

ERISA is very specific about who is a qualified investment advisor. An advisor must meet the following 3 criteria;⁷

- The advisor must have the power to manage, acquire or dispose of any asset entrusted to him
- The advisor must be registered as an investment advisor under the Investment Advisor Act of 1940 or else be a bank or insurance company as defined by ERISA
- The advisor must acknowledge in writing that he is a fiduciary of the plan.

Compensation and ERISA

Generally speaking, real estate professionals have historically been paid according to how much money they made for their clients. Typically, their compensation is tied to the performance of the property they buy or the investment they structure. They may receive some equity in the property or may receive some form of performance based fee on a share of the property’s cash flow once the client has received a minimum level of return. The pension fund business however, has paid for its investment help quite differently. Traditionally, the majority of investment advisors for pension funds have been paid only a fixed fee based on the amount of money under management.

There has been some debate over whether a fiduciary under ERISA can take a piece of the deals that he completes for his clients or be paid any form of performance

⁶ Ibid.

⁷ Ibid., p. 72

fee. The DOL, which interprets the law, is not certain whether it should permit investment advisors from doing so. The reason: Under a strict reading of ERISA, a fiduciary should not benefit from an investment he advises the plan to make. In fact, individual representatives of the DOL have, from time to time, expressed their views that real estate performance fees are generally not consistent with ERISA's fiduciary principles.⁸ For instance, a plan fiduciary would violate the "duty of loyalty" rule, as well as the prohibition on conflicts of interest (which are discussed later in this chapter) if a fiduciary exercised its authority or control for the purpose of benefiting the fiduciary, even if the action incidentally benefited the plan. An example of this would be if the fiduciary sold a property in order to accelerate its receipt of performance compensation, or to lock in a performance fee, or if the fiduciary caused the plan to incur undue risk in order to enhance the fiduciary's compensation.⁹

While fixed, or asset-based, fee arrangements may be new to the real estate business, they are by no means new to the pension industry. Pension sponsors typically manage their funds by farming them out to various investment management firms. These firms, which until recently were forbidden under SEC regulations to collect any type of performance fee, typically receive a percentage of the market value of the total amount under management. While the norm for stock and bond managers is less than 1% of the market value of assets per year, real estate managers traditionally made anywhere from .5% to 2% of assets under management. The wide range in the fees typically depended on whether the advisor was managing a commingled fund or managing individual accounts for specific funds. Regardless of the specifics, this much is true; the more money you manage, the more money you make.

⁸ Krueger, p.18

⁹ Ibid., p.19

Legality of Performance Based Fees

The legality of performance fees under ERISA depends primarily on the application of four principles:¹⁰

- The duty of loyalty
- The prudent man rule
- The prohibitions relating to fiduciary conflict of interest
- The requirement that the fees and the arrangement pursuant to which fees are paid must be reasonable

Although each of these principles may effect the legality of performance fees, the greatest tension arises from the third principle. That principle may be asserted as a basis on which certain performance fee structures are per se violations of ERISA's prohibition of fiduciary conflicts.

Generally, guidance as to whether performance fees may be consistent with the foregoing ERISA principles can be obtained from the following sources:¹¹

- DOL regulations and case law that apply those ERISA principles in other contexts
- Three DOL advisory opinions (securities fees letters) that approved payment of performance fees to entities that provided services related to investments in securities.
- Three prohibited-transaction exemptions that DOL granted with respect specific performance-based compensation for real estate investments (PTEs)

The ERISA rules that apply to performance fees are not directly applicable to governmental plans that are tax-exempt under sections 401 and 501 of the Internal Revenue Code.¹² However, the resolution of the issues relating to the performance fees under ERISA may effect many governmental plans since certain state laws and regulations and many investment management agreements incorporate ERISA-type provisions.

As discussed in chapter one, performance fees include any fee structure under which the investment manager's fees vary according to the performance of the portfolio,

¹⁰ Ibid., p.18

¹¹ Ibid.

¹² Ibid.

other than on the basis of a fixed percentage of assets under management. Typically, a performance fee entitles the manager to share in a percentage of the return invested in excess of a pre-determined hurdle rate. In the securities fees letters the DOL approved three types of performance fee structures:¹³

- Fees based on a percentage of the appreciation of managed assets
- Fees consisting of a base fee plus a percentage of appreciation
- Fulcrum-fee arrangements under which the fees are increased or decreased according to a manager's performance relative to a pre-determined index

Each of these fee structures could be applied, with appropriate modifications, to the management of real estate assets. In the real estate PTEs, the DOL permitted the following fees¹⁴:

- A fee based on the percentage of the plan's profits after a return of contributions
- A fee based on a percentage of cash flow plus disposition or refinancing proceeds after deducting (1) an annual cumulative, non-compounded 10 percent return to the plan on net capital contributions and (2) a disposition fee equal to a percentage of net disposition proceeds remaining after return of all capital plus a specified annual return to the plan

Unlike advisory opinions, which reflect DOL views, which are not binding on the courts, a prohibitive transaction exemption (PTE) is binding to the extent that it exempts a specific transaction from the statutory prohibitions.

Duty of Loyalty

An ERISA fiduciary, including an investment advisor, must discharge his duties solely in the interests of plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses

¹³ DOL Advisory Opinion 86-20A (issued to BDN Adviser, inc., on Aug 29, 1986), DOL Advisory Opinion 86-21A (issued to Batterymarch Financial Management on Aug. 29, 1986) and DOL Advisory Opinion 89-31A (issued to Alliance Capital Management on Oct. 11, 1989)

¹⁴ PTE 83-53 (issued to First Equities Institutional Realty Investors on April 1, 1983), 47 Fed. Reg. 54580; PTE 88-73 (issued to Quevado Properties, Ltd., on July 29, 1988), Fed. Reg. 18429; and PTE 89-13 (issued to Coldwell Banker Commercial Group on March 10, 1989), 54 Fed. Reg. 702

of administering the plan.¹⁵ This rule is sometimes called the “duty of loyalty” or the “exclusive benefit rule”

Some have argued that the duty of loyalty precludes performance fees, because the fiduciary is working for his own benefit as well as the plan. Case law, however, supports the proposition that the exclusive benefit rule is not violated merely because an action incidentally benefits a fiduciary, provided that the fiduciary exercises their authority “with an eye single to the interests of the plan”.¹⁶

Prudent Man Rule

All ERISA fiduciaries are subject to the Prudent man rule, which, as we saw in chapter two is the principal investment direction given by ERISA. Fiduciaries must invest the assets of the plan as a prudent man would. In the case of the delegated fiduciaries, such as investment advisors, this means the advisor must invest the assets under his care “for the exclusive benefit” of the plan participants.¹⁷ Additionally, he must diversify the investments he makes for the fund in order to “minimize the risk of large losses”.¹⁸ However, beyond the rule to diversify, the prudence regulations give an investment manager absolutely no instruction as to how to invest, other than to be careful, professional and exercise good judgment.

It is important to realize that the prudent man rule, as enforced by the DOL, is designed to protect fools from themselves and the plans from criminals.¹⁹ It was not designed to discourage plan investments in real estate or other new investments, or to regulate how these investments were structured.

¹⁵ Krueger, p.19

¹⁶ Ibid.

¹⁷ McKelvey, p.73

¹⁸ Ibid.

¹⁹ Ibid.

Compensating the Prudent Man

An ERISA fiduciary must discharge its duties with care, skill, prudence and diligence under the circumstances, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.²⁰

In the context of performance fees, the prudent man rule applies principally to the plan fiduciary who authorizes the performance fee structure. However, it may also effect the investment advisor. For instance, an investment advisor would clearly violate that rule if he took imprudent actions in order to effect the timing of the payment of those fees. Furthermore, the DOL has suggested that the investment advisor could be liable under ERISA's provisions relating to cofiduciary liability, if the plan acted imprudently in entering into the performance fee arrangement with knowledge that the plan fiduciary was acting imprudently.²¹

It is important to note that the actions of a plan fiduciary in authorizing performance fees to be paid to another party, or investing in a vehicle that provides for performance fees, are always judged by the prudent man rule. The authorizing fiduciary must therefore carefully review the reasonableness of the performance fee arrangement, the reasonableness of the fee, as well as the incentives that the arrangement creates. The fiduciary is held to a high standard of care in reviewing performance fees. The DOL expressed its views on this matter in the Securities Fees Letters as follows:

“The Department... expects a plan fiduciary, prior to entering into a performance-based compensation arrangement, to fully understand the compensation formula and the risks associated with this manner of compensation, following disclosure by the investment manager of all relevant information pertaining to the proposed arrangement. In addition, the plan fiduciary must be capable of periodically monitoring the actions taken by the manager in the performance of its investment duties. Thus, in considering whether to enter into an arrangement of the kind described in your letter, a fiduciary should take into account its ability to provide adequate oversight of the investment manager.”²²

²⁰ Krueger, p.19

²¹ Ibid., p.20

²² DOL Advisory Opinion 86-20A

Many industry experts agree that the intensive management activities required of a real estate investment advisor may make performance compensation more appropriate for management of real estate than for management of other asset classes. Those very activities, however, as well as the associated discretionary control over plan assets and the lack of accurate performance indices against which to measure performance, may require the fiduciary authorizing the performance fee to engage in more intensive scrutiny in the case of its real estate manager than in the case of asset managers of other asset classes.

One way for an investment advisor to limit the liability exposure imposed by the prudent man rule is to limit performance fee arrangements to large plans that have sophisticated fiduciaries or to plans that employ experts to advise them on fee structure and require ongoing monitoring. In fact, the securities fees letters and the Coldwell Banker real estate PTE each limit investors to plans with aggregate assets of at least \$50 million. In one advisory opinion, the DOL noted that the investment manager's representation that plans of that size are sophisticated and able to select and monitor the performance of the investment advisor.²³

Prohibited Transactions

In the real estate business it is common for professionals involved in the sale, refinancing or leasing of a property to receive a commission for their services. However, ERISA prohibits pension plans from paying themselves commissions.

This ban on commissions is just one of many prohibitions against self-dealing by investment advisors set out under a section of ERISA entitled "Prohibited Transactions". Section 406 of ERISA prohibits fiduciaries from engaging in "certain transactions" with persons who are "parties of interests" of the pension plan.²⁴ Put simply, section 406 and how it defines "parties in interest" is the root of much of the problems pension plans have with investing in real estate.²⁵

²³ DOL Advisory Opinion 89-31A

²⁴ McKelvey, p. 76

²⁵ Ibid.

In essence, nearly everyone who sets eyes on the plan or knows or is related to a fiduciary can be construed as a “party in interest”. The most obvious of the long list include the following; the sponsoring employer of the plan, people who provide services to the plan, unions whose employees are covered by the plan and of course other fiduciaries. In addition, the law prohibits the relatives, subsidiaries, major shareholders or joint-venture partners of these people from dealing with the plan, for they too are considered parties in interest.

A pension plan and a party in interest can not sell, exchange or lease property to each other or furnish services to each other. Furthermore, a party in interest is forbidden from using plan assets for their own benefit. As one former DOL lawyer, who dealt extensively with section 406, stated, “What congress was trying to do with this section 406 was to keep the plan sponsors from using the pension fund as their own private bank”,²⁶

Clearly it is a worthy goal, especially when one hears the stories of how small undercapitalized firms had drained the pensions in order to buy new machinery or even meet payroll. However, how could such a well intended and important section of ERISA contain such problems for ethical real estate advisors and plan sponsors?

Actually, the prohibited transactions are not the problem. If the law had been written such that prohibited transactions were not allowed under any circumstances, and that would have been the end of it. Pension funds would stay away from any investment that had a hint of conflict of interest. The probability that they would have invested in real estate at all would be quite slim. However, investment advisors and plan sponsors are able to file for exemptions and that is where the trouble lies. The manner in which these exemptions are granted confuses everyone about what the true limits are on dealings with parties of interest.

²⁶ Ibid.

Prohibited Transaction Exemptions

After congress wrote the prohibited transaction section, they realized that the law was so sweeping that they should allow exemptions. After all, some actions which would be considered self-dealing under a strict interpretation of the law could actually benefit the plan. Therefore, congress decided that there should be exemptions to the prohibited transaction rules.

There are two types of exemptions: statutory and administrative. Statutory exemptions are actually written into ERISA. They are narrow, specific exemptions that permit pension funds to do things like lease space from a party in interest. While the statutory exemptions cover specific actions, congress also realized that there would be certain instances where a specific transaction would be considered a violation under a strict reading of the law, but not if the transaction were carefully reviewed. Congress therefore gave the DOL the power to grant an exemption from the prohibited transaction rules for a particular transaction. Such an exemption is called an administrative exemption.

If a company was interested in entering into a performance based compensation agreement, the company could apply to the DOL, requesting an administrative exemption. If the DOL thought that it was a good deal for the pension plan, they would approve it with minor or sometimes major modifications. For instance, in the real estate PTEs granted to Quevado Properties , Ltd., and First Equities Institutional Realty Investors, the conflict associated with the performance fees that are payable upon the disposition or refinancing of properties was mitigated by a requirement that the disposition or refinancing be approved independent fiduciaries representing holders of a majority of the partnership interests.²⁷ Another example was the Coldwell Banker real estate PTE, in which the DOL specified that while the performance based fee was valid, no performance fee will be payable until (1) all properties have been sold and the proceeds distributed to the plan or (2) the removal or resignation of the trustee. In the

²⁷ See note 5

latter case, the performance fee was to be based on an appraisal of the properties conducted by an independent appraiser approved by the plan.²⁸

On the surface the procedure appears to be deceptively simple. In practice it drives the pension funds and the real estate advisors mad. The biggest problem with the exemption procedure is that congress never designed one. ERISA merely ordered the DOL to write the rules for granting these exemptions. It is important to note that it makes no difference whether or not a transaction is reasonable or fair to the plan. If the transaction is in violation of the prohibited transaction rule than one can not proceed further without being granted an administrative exemption from the DOL.²⁹

Securities Fees Letters

In addition to the real estate PTEs, the Securities Fees Letters provide guidance for interpreting the application of the prohibited transaction rules to performance based fee arrangements. The DOL concluded that performance fees under the particular circumstances examined in the securities fees letters would not constitute per se violations of the section 406(b) prohibitions, because investment advisors would not exercise their fiduciary authority to cause a plan to pay them an additional fee, and they would not be acting on behalf of, or representing, a party whose interests were adverse to the plan. Each of the fee arrangements discussed in those letters had certain common terms which in the aggregate, resulted in the DOL's conclusions. They are as follows:³⁰

- *Readily available market quotations.* The performance arrangements were limited to accounts that would generally be invested in securities for which market quotations would be readily available, although a small percentage of a managed account could consist of securities for which market quotations would not be readily available.
- *Fixed valuation date and computation period.* The valuation date as well as the length of the computation period would be pre-established and set forth in the investment management agreement.

²⁸ See note 5

²⁹ Mckelvey, p. 77

³⁰ Krueger, p. 21

- *Valuation.* Investments would be valued on the basis of market quotation. Investments for which no market quotation is readily available, such as with real estate, would be valued by an independent party selected by the plan. The valuation would be binding on the plan.
- *Calculation of appreciation/depreciation.* The performance fees would be based on all realized capital gains and losses and all unrealized capital appreciation and depreciation, plus interest, cash and stock dividends and any rights, warrants or other distributions received by the plan during the computation period.
- *Standardized index.* The index used for a base plus fulcrum fee would be an appropriate, generally accepted standardized index of securities or a customized index tailored either to the investment managers approach or to the client's investment objectives. For real estate this would most likely be the Russell-NCREIF index.
- *Treminability of the arrangement.* The plan could terminate the contract on reasonably short notice.

Although fee arrangements with the characteristics described in the securities fees letters eliminate many potential conflicts, they do not eliminate all possible circumstances under which an investment advisor's interests might conflict with a plan's interests. For example, the fee structure previously described may tempt an investment manager to "game" the fees by investing the plan's portfolio in investments that are riskier than those in the performance index. An advisor responsible to several plans might increase the risk in each plan's portfolio but diversify the risk across the portfolios. He could reduce the risk when performance was better than the index or significantly increase the risk when the return was below the index.³¹ Obviously, this is more of a concern with Wall Street money managers than with real estate investment advisors. However, as real estate performance indices evolve into a more useful tool for measurement of performance, this will become an increasingly important issue.

³¹ Kritzman, "Incentive Fees: Some Problems and Some Solutions", *Financial Analysts Journal*, 21 (Jan - Feb, 1987)

Conclusion

While it remains clear that the DOL has and continues to discourage the practice of real estate performance fees, there has been no official position of the DOL to that effect. Furthermore, the DOL's interpretation and the subsequent case law in analogous areas seem to suggest that, in appropriate circumstances, real estate performance based fees do comply with ERISA guidelines, provided that the fiduciaries act prudently and exercise their fiduciary authority for the exclusive benefit of the plan participants.

Chapter Four

Survey Results

Overview

In order to determine what, if any, are the industry standards regarding pension advisors fee structures, a comprehensive survey (see Appendix I) was sent to over 50 of the top investment advisors in the Pension Real Estate Association (PREA) to be filled out for each of their largest 5 portfolios. The survey hoped to identify trends in advisor's fee structures as well as measure the magnitude of the trend towards performance based fee structures.

Realizing that much of the information requested in the survey is proprietary in nature, the survey was designed to keep the individual participants and portfolios anonymous. While the final results have been tabulated and appear in this chapter, all information regarding specific portfolios and advisory firms have been kept confidential. For this reason, no information regarding the size and the nature of the plan sponsor (i.e. public vs. Private) appears in the results presented in this chapter.

Participation

Of the approximately 50 surveys that were sent to PREA members, only 16 were completed and returned. While there were several reasons given for firms lack of participation (not applicable to their business, too time consuming, et cetera), clearly the most cited reason was the proprietary nature of the subject matter. However, the 16 completed surveys include a total of 39 portfolios and fee structures, which represents the largest and most comprehensive survey of pension advisory firms' fee structures to date.

Trends

The main purpose of this survey was to determine how prevalent performance based fee structures are in the pension advisory community. In addition, the survey had hoped to identify other significant trends in advisors fee structures that may have arisen in the last few years.

The survey was successful on both counts. First and foremost, the survey proved that the perceived trend towards performance based fee structures is in fact a reality and may be more widely accepted than originally thought. In fact, of the 39 portfolios surveyed, 29 currently use some form of performance based fee structure. This figure represents almost 75% of the portfolios surveyed. In addition, every portfolio formed within the last year (Aug. 1994 - Aug. 1995) uses some form of performance based fee. Clearly, performance based fees are here to stay. The survey was also successful in identifying a significant trend in the form of these performance fees

Preference for Absolute Performance

Perhaps the most surprising trend, other than the overwhelming number of performance fee structures, has to do with the form of these performance fees. As performance fees have continued to grow in popularity within the pension community, industry experts and academics alike, have debated the merits of basing fees on relative performance as opposed to absolute performance (see chapter five). Many have argued that the concept of relative performance is indeed the purest and fairest form of an incentive since it rewards the advisor on the application of their skill and minimizes the effect of events outside their control (i.e. general market movements). The concept of relative performance is essentially one in which the advisor is rewarded for outperforming a relevant benchmark, such as the Russell-NCREIF index. Remarkably, of the 29 performance based fee structures, not one utilized the concept of relative performance. All 29 fee structures are based on some form of absolute performance. It appears that the lack of accurate performance indices against which to measure performance is a larger practical problem than originally believed.

However, the overwhelming preference for basing fees on absolute performance appears to be where the similarities end. There are fee structures based purely on cash flow or NOI, and there are fees based solely on participation over a pre-determined performance objective. Even the performance objectives varied widely regardless of whether they were based on real or nominal returns. For instance, some fees are based on

high participation percentages over a high performance objective, while others are based on incremental increases both in participation percentages and performance objectives.

Not surprisingly, most fee types fall into the category of hybrid performance fee structures. Examples of this would be fee structures that allowed the advisor to share a percentage (typically 6% to 8%) of the cash flow or NOI, as well as a share of the return over a hurdle rate on the sale of the assets. However, there are certainly no clear standards for this practice as combinations of every type of fee structure were reported. In fact, of the 29 performance fees, 30% were combinations of a performance fee and a fixed fee based on assets under management. Undoubtedly, one of the practical benefits of the performance based fee structure is choice. It appears that fee structures are being tailored to individual plan sponsors investment needs.

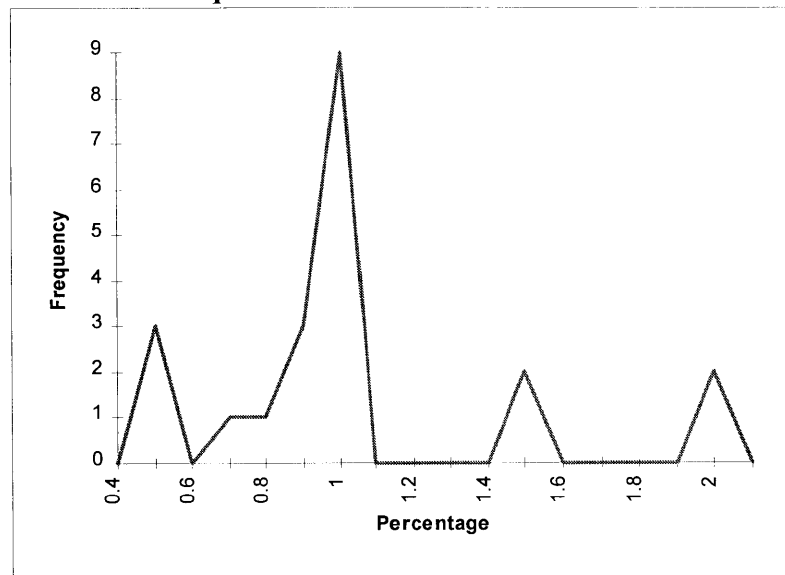
Results

Due to the complexities of many of the fee structures reported, there are several overlapping response sections. For instance, a fee structure may include a fixed fee based on assets under management, a shared percentage over a pre-determined hurdle-rate and a disposition fee tied to performance in the form of real rate of return. Keeping this in mind, the following represents the survey results broken out into individual response sections.

Acquisition Fee

- 70% of fee structures include some form of acquisition fee.
 - 20% of the acquisition fees are based on equity and range from .6% to 1% of the value of the equity. The average fee is .8% of the value of the equity.
 - 80% of the acquisition fees are based on the total cost of the asset. The fees ranged from .5% to 2% of the value of the asset and averaged 1.05% (see exhibit VII).

Exhibit VII
Frequency Distribution
of Acquisition Fees Based on Total Cost



Asset Management Fee

- 74% of fee structures are at least partially based on performance.
 - 90% of the 74% are at least partially based on some form of hurdle rate (see exhibits XI and XII).
 - 55% of the 74% are at least partially based on some form of revenue stream (evenly split between cash flow and NOI).
 - The fee structures based on percentage of NOI ranged from 4.5% to 10% with the average approximately 7.8% (see exhibit VIII).
 - The fee structures based on percentage of cash flow ranged from 5% to 8% with the average approximately 6.9% (see exhibit IX).
- 13% of fee structures are based solely on a fixed percentage of assets under management. Of these fee structures, asset value was determined by:
 - Appraisal value (60%).
 - Original cost of asset (30%).
 - Lower of the two (10%).
 - The fixed fees ranged from .3% to 1.88% with the average approximately .8% (see exhibit X).

Exhibit VIII
Frequency Distribution of
Revenue Participation Percentage Based on NOI

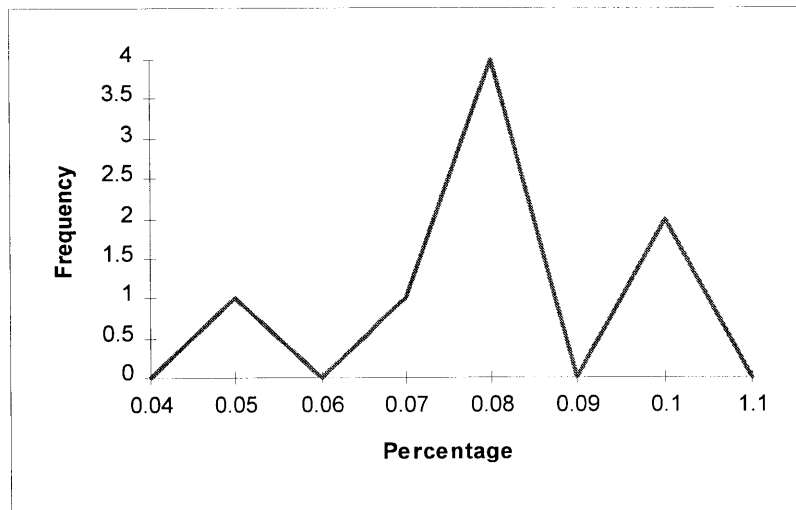


Exhibit IX
Frequency Distribution of
Revenue Participation Percentage Based on Cash Flow

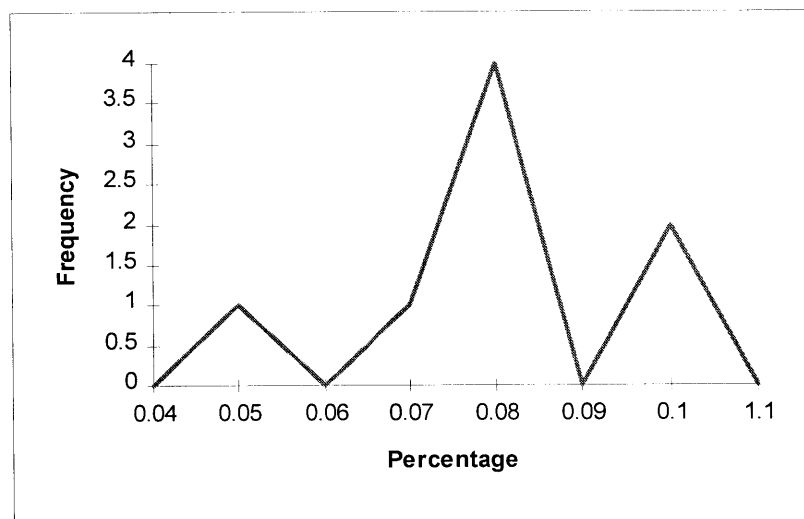
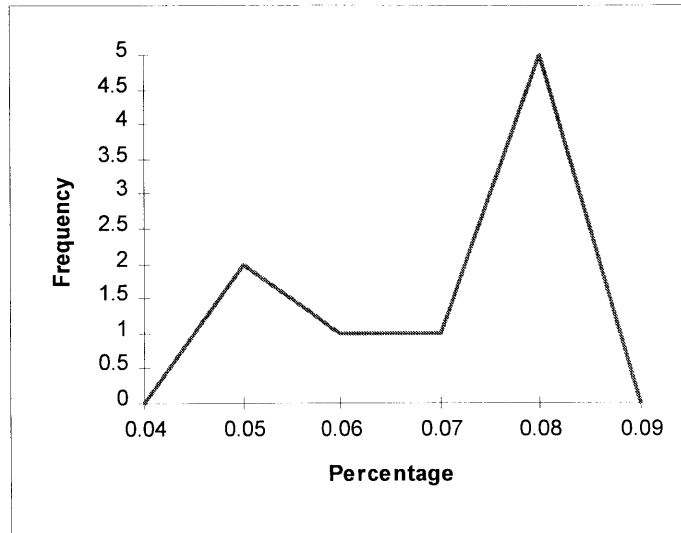


Exhibit IX
Frequency Distribution of
Fixed Fees Based on Assets Under Management



Financing Fee

- Only 5% of the fee structures included a fee for financing.

Disposition Fee

- 80% of the fee structures include a disposition fee.
 - 94% of the disposition fees are tied to performance (see performance objectives).
 - 6% of the disposition fees are based on flat fees.

Performance Objectives

- 72% of performance fees are based on some form of hurdle rate.
 - 76% of these fee structures are based on a real rate of return with an average performance objective of 6.19%. The following is a sample of some of the real rate of return hurdle rates and participation percentages used by the survey participants.

Exhibit XI

Real Rate of Return Hurdle Rates
10% of excess cash flow after 4% real rate of return
10% of excess cash flow after 6% real rate of return
8% of excess cash flow after 6% real rate of return
20% of excess cash flow after 5% real rate of return
15% of excess cash flow after 8% real rate of return and 30% of excess cash flow after 12% real rate of return
15% of excess cash flow after 9% real rate of return and 30% of excess cash flow after 13% real rate of return
15% of excess cash flow after 9% real rate of return and 30% of excess cash flow after 13% real rate of return
15% of excess cash flow after 5% real rate of return
20% of excess cash flow after 5% real rate of return
9% of excess cash flow after 6% real rate of return
15% of excess cash flow after 6% real rate of return
15% of excess cash flow after 6% real rate of return
15% of excess cash flow after 6% real rate of return
10% of excess cash flow after 8% real rate of return and 20% of excess cash flow after 9% real rate of return and 25% of excess cash flow after 10% real rate of return
7% of excess cash flow after 6% real rate of return and 9% of excess cash flow after 7% real rate of return and 11% of excess cash flow after 8% real rate of return and 15% of excess cash flow after 10% real rate of return

- 24% of these fee structures are based on a nominal rate of return with an average performance objective of 9.3%.

Exhibit XII

Nominal Rate of Return Hurdle Rates
20% of excess cash after 9% nominal rate of return
20% of excess cash after 9% nominal rate of return
20% of excess cash after 10% nominal rate of return
15% of excess cash after 9% nominal rate of return
1% of excess cash after 1% nominal rate of return and 2% of excess cash after 2% nominal rate of return and so on...

- 18% of performance fees are based solely on revenue stream (see exhibits VIII and IX)

Conclusion

Despite the current enthusiasm for performance based fees, they are not without problems (as will be discussed in the next chapter). However, most of these problems can be averted by plan sponsors closely monitoring the activities of the advisors and carefully developing, in conjunction with the advisors, a fee structure that creates the appropriate incentives and closely aligns both parties' interests.

Chapter Five

Performance Based Fees

The Basic Issues

Overview

It's not hard to fathom why performance fees have attracted so much interest within the pension community lately. Pension advisors want and expect their fees to increase and pension plans expect higher returns or a reduction in the fees they pay. Additionally, the incentive concept is a crucial underpinning of a free market economy. It seems only natural that the pension community would eventually embrace the concept.

As discussed in the previous chapters, advisors fees have historically been based on the value of assets under management. Obviously, the greater the dollar amount of the portfolio, the greater the fee. Not surprisingly, this traditional compensation structure bears little relation to typical investment performance objectives, such as outperforming the market. Asset-based fees are akin to compensating corporate officers according to the size of their company or division, instead of profits.¹ As a result, MIT Center for Real Estate Chairman Blake Eagle contends that "The incentive under the traditional asset-based fee structure is to grow assets under management, rather than to grow the returns of those assets"²

Performance based fees are designed to provide a more direct relation between the fee an investment advisor receives from their clients and the performance of the portfolio he manages for those clients. Tying advisor compensation directly to the portfolio's performance objective is seen by many as a way of preventing pension funds from paying high fees for mediocre results. However, is this recent trend merely a knee-jerk reaction to poor real estate returns over the last decade that will fade away as returns increase? Who is interested in performance fees? Who wins? Who loses? What form will these performance based fees take? What do they accomplish? What are the undesirable side

¹ Davanzno, L. "Performance Fees for Investment Management", *Financial Analysts Journal*, (Jan-Feb, 1987)

² Interview with Blake Eagle (July, 1995)

effects? This chapter will attempt to answer or at least address these issues as a way of better understanding the implications of this prevailing trend.

Current Incentives

Every portfolio manager wants his investments to turn out well. If management fees are based on the value of the assets under management (as historically has been the case), then the higher returns on the portfolio translate into a higher value of assets under management and, therefore higher fees to the manager. Therefore, it can be argued that the traditional compensation structure of the asset-based formula does reward managers on the basis of performance. In addition, any future bonus is built into the base so that the advisor is also rewarded in subsequent periods for performance in the current period.³

In reality, the biggest incentive to superior performance is in fact a negative one. If a manager performs poorly and is fired, he loses the revenue stream from that account and suffers from the bad publicity that results.⁴ This threat clearly provides the advisor with a strong incentive to perform well in both the absolute and relative sense. Under this structure, the advisor is motivated by the incentives of keeping existing accounts and getting new ones.

The traditional, and common, practice of instituting a sliding scale and setting fee schedules as a declining function of the assets under management (as discussed in chapter two with the Heitman example) certainly does provide a small positive performance based incentive. In fact it is seen as quite logical in terms of reflecting the economies of scale involved in managing large accounts. It does not, however, provide a logical incentive for the investment advisor⁵. After all, wouldn't superior performance on a large account be more valuable than similar performance on a smaller account?

Furthermore, the implied performance related component of the fee is not necessarily tied to the value an advisor is able to add. For instance, under this arrangement, a "good" advisor in a down market may get less than a "poor" advisor in an

³ Grinold, R. "Incentive Fees: Who Wins?, Who Loses?" *Financial Analysts Journal*, (Jan-Feb, 1987)

⁴ Ibid.

⁵ Ibid.

up market. Traditional incentives had worked by threatening managers with the loss of an account, rather than by actively promoting strong performance.

Moral Hazards of the Asset-Base Fee Structure

In chapter one, the distinction was made between “performance” and “incentive” in recognition of the fact that many fee structures provide advisors with incentives that are not necessarily related to performance. For instance, a fee based on a fixed percentage of assets under management may provide a manager with an incentive to invest the assets as soon as possible. This incentive is particularly strong where, as is common, the investment advisor has no assurance that if he disposes of an asset he will be authorized to reinvest the proceeds. However, a fee structure that bases the fee on original cost, where the manager anticipates that he will be authorized to reinvest the proceeds, may give the advisor an incentive to maximize current cash flow regardless of the effect on long term value. Furthermore, fees that are based on gross asset value may provide advisors with the incentive to leverage the assets and fees based on net asset value may provide advisors with an incentive to acquire properties as quickly as possible on a non-leveraged basis.

What Performance Based Fees Should Accomplish

Ideally, any new performance based fee structure should address the deficiencies of the traditional asset-based structure. Among the important criteria for a satisfactory fee schedule are the following:⁶

- *The fee must be fair and reasonable:* This is a subjective judgment that must be made in the context of particular facts and circumstances measured against relevant external benchmarks. The fee should be appropriate to the type and size of the account. Plan sponsors expect an advisor to add value to the investment process. However, advisors should be rewarded for the application of their skill and the impact of external events out of their control (i.e. general market movements) should be minimized.

⁶ Record, E. “Incentive Fees: The Basic Issues”, *Financial Analysts Journal*, (Jan-Feb, 1987)

- *The fee should be clearly understood:* For the traditional asset-based fees, a straightforward statement of the amount of the fee and when it is to be paid is a simple process that holds very few surprises. However, fees based on relative or absolute performance or contingent upon some future event requires much more analysis. Particularly with more complicated fee structures, advisors should be prepared to explain how and why the fee operates, and plan sponsors should be prepared to conduct an independent analysis of the advisors explanation.
- *Fees should not cause unacceptable conflicts of interest:* Advisors have a fiduciary duty to act in the best interests of the plan sponsors. Fees are only one of many areas in which the activities of the advisor and the relationship with the plan sponsor must meet this standard. Few argue with the concept that an advisor can expect to do well if the plan sponsor does well. However, the fee should not provide the advisor with an inherent incentive to take actions that may benefit the advisor but may not be in the best interests of the plan sponsor.

Performance Fee Components and Issues

As demonstrated in chapter four, there is no standard formula for performance fees, since any fee tied directly to an advisor's performance can be thought of as a performance fee. However, a performance based fee formula generally includes the following components:

- Performance objective
- Acquisition fee
- Asset management fee
- Bonus formula
- Valuation Method
- Time Period

Performance objective

The investment and performance objective of most plans is to invest in high quality real estate over long periods of time earning a real rate of return usually greater than 6%. The advisor's objective is to assist and service the plan to meet this goal. Performance objectives come in several forms and essentially are designed to enable the advisor to share in the upside over a pre-determined return or hurdle rate. For instance, if the performance objective is a 6% real rate of return, then the advisor will receive a certain percentage of every dollar received over that hurdle rate. The success of a performance fee depends in large part on the selection of a realistic performance objective, or hurdle rate, that accurately reflects the investment objectives of that particular portfolio.

Furthermore, the performance objective should be realistic enough to create an incentive. As Boston based Cabot Partners president Robert Anglund pointed out "If the performance objectives are unattainable, then the performance fee structure actually eliminates all of your incentives because you realize that you have no chance to earn a profit on that account".⁷

There are numerous factors that should be considered in establishing an advisor's hurdle rate. They include the overall market conditions, property type, geographic distribution as well as the advisor's historical performance. The key is for the decision to be made jointly between the sponsor and the advisor, so there is agreement that the hurdle rate is indeed a realistic expectation.

Acquisition Fee

Historically, most asset-based and performance based fee structures have included acquisition fees. These up-front fees generally range from .5% to 2% of the value of the property acquired. The advisor receives the one-time acquisition fee to cover overhead, due diligence and various out of pocket expenses for locating, analyzing and closing the acquisition.

⁷ Interview with Robert Anglund (July, 1995)

The problem with the acquisition fee is that it rewards transactions rather than performance. In addition, high acquisition fees tend to create an incentive for the advisor to purchase higher priced properties. The higher the price of the property, the greater the acquisition fee. For example, a 2% acquisition fee on a \$10 million office building and a \$100 million office building total \$200,000 and \$2,000,000 respectively. A significant difference indeed. As a result, many plan sponsors have recently negotiated these fees down to the level where the fee merely covers costs, thereby eliminating this problem.

Asset Management Fee

As discussed in previous chapters, the primary compensation to the pension advisor has historically been the yearly asset management fee, based on the periodic appraisal of the real estate portfolio. In addition to the incentive to create high appraisal values and thereby higher fees, this arrangement also provided no incentive for the advisor to maximize real estate values that may only be realized upon the refinancing or disposition of the property.

However, there are substantial costs associated with managing a real estate portfolio and tying an advisor's entire asset management fee to the performance of the portfolio may be too risky for even the most entrepreneurial of advisory firms. A more reasonable, and in fact more common performance arrangement, is a hybrid combination of a performance fee and a fixed management fee. This arrangement includes a base fee that is paid to the advisor regardless of the performance of the portfolio, but represents a substantial discount from the normal fee schedule, as well as some form of a performance fee. There are a number of ways to establish this base fee. One of the more common approaches would be to set a base fee equal to the manager's direct costs for maintaining the account. Under this method the yearly asset management fee merely covers the overhead rather than providing any real profit for the firm.

Bonus Fee

A common misunderstanding about the bonus portion of a performance based fee is that it is intended to provide the advisor with an incentive to earn a higher return than he would return under his normal fee schedule. This is not the case. The bonus, if properly structured, is designed to provide a more direct recognition of an advisor's performance - good or bad.⁸

There are many ways of calculating an advisor's bonus. However, all methods should create a bonus that represents a participation in the realized and unrealized gains in excess of an appropriate hurdle rate or benchmark. This hurdle rate could be based on a specified real or nominal rate of return. The benchmark, as will be discussed later, is typically tied to the Russell-NCREIF index. Regardless of the method used, this bonus participation is the element of a performance fee that links the fee to the portfolio's performance. In fact, many performance fees are not even based on hurdle rates or benchmarks, but rather upon a percentage share of net operating income (NOI), cash flow and/or gain on sale and net sale proceeds. A simple and effective bonus calculation should ideally allow the advisor to earn a total fee (bonus fee plus base fee) equal to the advisor's normal fee when the performance objective has been achieved. Under this scenario, if the advisor earns return above the his objective, he receives an additional bonus.

The sponsor may keep the bonus participation rate constant across the advisor's excess return. For instance, a common bonus formulas is referred to as the "10 over 10" fee structure. The advisor receives 10% of every dollar distributed to the plan over a 10% real rate of return.⁹ Obviously, the level of the hurdle rate and the participation percentage varies greatly depending on the presence and the size of the base fee and the overall fee package. For instance, the sponsor may increase the bonus participation as the (NOI) increases, only to lower the participation rate after the portfolio reaches its hurdle rate. This form of bonus compensation is appropriate if the sponsor is less interested in additional return, than in achieving the performance objective.

⁸ Davanzo, p.17

⁹ Interview with Fred Wasson, Westmark Realty Advisors (July, 1995)

Many bonus formulas are based purely on cash flow as a means to avoid the conflict with the appraisal process and other valuation methods. However, while cash flow bonus formulas provide strong incentives to increase cash flow, they unfortunately do not provide the proper incentives to protect the property's long term value. If an advisor's compensation is linked directly to cash flow, there is an inherent incentive to avoid depleting the cash flow stream for such items as maintenance and capital expenditures. A property that is denied proper maintenance and capital expenditures will eventually lose its competitive advantage in its market and will ultimately decrease in value, which is not in the best interests of the plan sponsor.

However, by combining the use of cash flow incentives and long term incentives, this problem can be alleviated. One arrangement, for example, enables the advisor to receive the same bonus participation percentage as the real rate of return based on original cost.¹⁰ So, if the return was 3%, the advisor would receive 3% of every dollar distributed over the 3% return. That number would increase to 4% when the return reached 4% and so on. In order to compensate for the incentive to increase cash flow at the expense of the long term value of the assets, the properties are appraised each year. If the properties appreciate 2%, and the NOI is 8% (based on cost), the advisor receives an additional bonus of 8% of the value of the 2% appreciation. Conversely, if the asset declined in value 2%, the advisor has a debit equal to the value of 8% of the 2% decline in value. This arrangement was carefully designed to increase cash flow, while at the same time protecting the long term value of the assets.

Valuation Methods

Unlike the stock and bond markets, which provide thousands of pricing points each day, real estate values are an estimate at best. As a result, it has always been very difficult to measure real estate returns on an ongoing basis. As previously discussed, the debate over appraised value versus market value has been haunting the industry since the earliest commingled funds. There continues to be widespread skepticism regarding the

¹⁰ Interview with Blake Eagle

appraisal process across the pension community and many believe that there will always be real or perceived conflict of interest in the appraisal process if the level of fee income is directly linked to the appraisal value. Aside from the conflict of interest issue, there remains the problem of the inaccuracy of appraisals as well. After all, a one year lag in appraisals could represent a significant amount in the level of fees.

The problem lies in the fact in order to realize a property's appreciation and show an accurate rate of return, the property must first be sold. No investor truly knows what he has made on a property until he has sold it. Of course, he will have some sense of how good or how bad an investment it is while he owns it, but he certainly will not know to the hundredth of a percent until the property is actually sold.

A portfolio's total rate of return consists of unrealized appreciation and income return. These two figures are obviously incestuously related. Each period, an appraiser will value each property by capitalizing the rent stream at what he considers to be the market cap rate. The amount the property's value increased or decreased since the last period is the unrealized appreciation or depreciation for that period. The appraiser cannot calculate a property's value without a cap rate, which is his estimate of the yield that investors are willing to accept on that type of investment.

The income portion of the return is computed by dividing the cash flow from the properties by the value at the beginning of the period and expressing the result as a percentage. The problem is that this is merely another form of what the appraiser did in the first place. Rather than starting with the cash flow, dividing it by the cap rate to come up with the value, he now starts with the cash flow, divides it by the value and comes up with the cap rate again. Except this time he calls it the income return or the yield.¹¹ Therefore, the yield for any given period is merely the cap rate the appraiser used that period. The portfolio's properties may be generating increasing amounts of cash for the plan sponsors, but the income figures do not truly indicate what the sponsors are making on their cash invested in that portfolio. The returns are not cash-on-cash returns.

¹¹ McKelvey, p.231

In order to avoid this problem, many bonus formulas base their returns on the original cost of the property. A purer form of this method is to completely rear-load the performance fee to the point that no bonuses are calculated until the sale of the property has occurred. This fee structure is most appropriate with closed-end funds, which have a definite life span of typically 7 to 10 years.

Unfortunately, with open-ended funds with infinite life spans this fee structure may cause advisors to become the victims of their own success. For instance, if the compensation arrangement is structured so that all performance fees are rear-loaded, the advisor will not receive his bonus fee until the sponsor decides to sell the property. If the advisor has been successful in generating high returns from this property, the plan sponsor may decide to hold the property for a prolonged period. Under this scenario, the advisor never receives his deserved bonus.

As a means of alleviating this problem, many arrangements allow for a “constructive” sale in the event a property is not sold after a pre-determined time period.¹² Under a “constructive” or pretend sale, the plan sponsor hires an appraiser and a fair market value is estimated for the property. However, the determination of the length of the time period creates other legal and incentive issues.

Time Period

The time period over which the performance is calculated is a critical factor that requires detailed analysis. If the fee structure is based on relative performance, it is imperative to understand how the portfolio or account can be expected to behave relative to the benchmark over various lengths of time. For instance, the benchmark may be appropriate if measured over the life of the account, but not at all appropriate over a shorter time period. Too short a period could subject the calculation to abnormal returns due to lease-up periods, capital improvements or large lease roll-overs

Performance fees measured over longer periods have several advantages. When a sponsor establishes a performance objective, it is typically measured over a 7 to 10 year

¹² Interview with Fred Wasson

period corresponding to the life of the fund. A performance fee measured over the same period as a manager's objective helps prevent a potential conflict between the manager's desire to maximize fee revenue and the sponsor's desire to maximize the plan's return.

It is critical that the incentive and the timing of the payment of the fee not be structured to create a real or apparent conflict of interest between the plan sponsor and the advisor. For instance, if the measurement period is too short the advisor may have an implicit interest in pursuing certain types of investments due to their short-term impact on the incentive fee, when in fact such an investment, may not be in the long term interest of the plan sponsor.¹³

As discussed in chapter three, the DOL concluded in the securities fees letters that the valuation date as well as the computation period should be pre-established and set forth in the compensation arrangement. The DOL is clearly more concerned with establishing a pre-determined valuation date than in establishing the length of the time period. They believe that if the computation period is left to the advisor's discretion, the advisor will have more ability to effect the timing and the magnitude of his fee, thereby violating the fiduciary laws of ERISA.¹⁴

These six components that make up a performance fee can obviously be modified in many different ways in order to achieve a compensation scheme that meets both the sponsor's and manager's needs.

Forms of Performance Fees

As performance based fees continue to grow in popularity within the pension community, different forms of performance fees are beginning to appear. Essentially, there are two types of performance fees: Those based on relative performance and those based on absolute performance.

¹³ Davanzo, p.18

¹⁴ Krueger, p.21

Relative Performance

The concept of relative performance is essentially one in which the advisor is rewarded for outperforming a relevant benchmark by a meaningful amount and is penalized by the same percentage for underperforming. However, it is important to note that the advisor under this scenario can earn the performance fee even if the absolute value of the portfolio declines. Conversely, the advisor can fail to earn the performance fee even if the absolute value of the account or portfolio rises. The idea is to reward relative performance.

Many industry experts believe that basing a bonus formula on the absolute performance of the portfolio is akin to rewarding, or penalizing an advisor based on events out of his control, such as general market movements. Steven Corkin of Aldrich, Eastman and Waltch agrees, “The market is going to define how you are going to do. You may be at the high end or the low end depending on the ability of your investment advisor - but the market will determine for the most part how you are going to do”.¹⁵ For instance, when the real estate market sky rockets, all real estate values increase significantly across the board. Why should the advisor get rich through performance fees when he had little to do with the overall market movements? Conversely, if the market bottoms out, the advisor should not be penalized either.

However, this form of performance fee is not without problems. Relative performance fees are much more applicable to money managers than to real estate managers because of the lack of accurate performance indices against which to measure performance.

¹⁵ Interview with Steven Corkin (June, 1995)

Problems With Real Estate Performance Indices

Since its inception in 1978, the Russell-NCREIF (RNI) index has become by far the most widely cited index of institutional grade commercial property returns in the United States. The RNI is based on the appraisal values of unlevered properties held for institutional investors in the portfolios of the member firms of the National Council of Real Estate Investment Fiduciaries (NCREIF). The index currently includes almost 2,000 properties with an appraisal value of over \$23 billion.

Although the RNI is certainly a rich source of information, industry experts have long questioned the accuracy of the RNI due to its apparent smoothness and the perception that it lags declines in property values.¹⁶ The quarterly RNI returns exhibit much less volatility than the market value indices of other asset classes and has at times failed to register movements in real estate market that were widely perceived by market participants. For instance, in the late 1980's the RNI failed to register significant declines in commercial property values at a time when many financial institutions were declared insolvent in large part due to the sharp decline in real estate values.¹⁷

The inherent problems that plague the RNI are rather understandable upon an examination of the appraisal process and the construction of the index. In lieu of transaction prices (less than 5% of the properties included in the RNI sell each year), appraisals are completed on all of the properties included in the index. These appraisals are done quarterly, but only include an outside appraisal once a year. With the in-house appraisals, there is a behavioral incentive to look back to last quarter's numbers to update the current numbers. This both minimizes effort and reduces the probability of "standing out".¹⁸ Additionally, these same problems exist with the once a year outside appraisal, although to a somewhat lesser extent. Consequently, at the property level, there tends to be appraisal smoothing in the sense that current values both lag the market and display lower volatility than is actually occurring.

¹⁶ Fisher, J., "Value Indices of Commercial Real Estate: A Comparison of Index Construction Methods", *Journal of Real Estate Finance and Economics*, 1994

¹⁷ Ibid.

¹⁸ Riddiough, Tim; Lecture delivered at MIT Center for Real Estate, Spring 1995

While many point to this appraisal lagging problem as proof of the index's inaccuracy as a reliable real estate performance index, others maintain that the RNI is the purest form of a performance due to the fact that it matches the valuation practices (appraisals) of many of the funds. As previously discussed in this chapter, the majority of funds use appraisals in some form or another to measure their portfolio's performance. Therefore, many believe that the RNI does serve as a reliable index by which to measure the performance of their portfolios.

Regardless of the debate over the appraisal process, the RNI has several other limiting factors. For instance, though the RNI returns are broken out by region and property type, the index often times it is not comparable to a particular portfolio's investment characteristics and therefore is not appropriate as a benchmark. In addition, the values the RNI are reported on an unlevered basis and therefore only represent an appropriate measure for all-cash purchases.

Absolute Performance of the Portfolio

In contrast to the concept of relative performance, many performance fees are based upon a percentage of the absolute net gains in the portfolio over some pre-determined set period of time. As discussed in the *Bonus Fee* section, in an open-ended portfolio or a separate account with definite life, the percentage might be calculated at specified intervals during the life of the portfolio or account. For instance, the fee could be calculated every five years and be set at 10 percent of the five year appreciation.¹⁹ In a portfolio or separate account with a definite life, such as a closed-end commingled fund, the calculation could be done at the end of the fund when all the proceeds are distributed or at specified intervals. However, it should be noted that this form of performance fee does not require that the bonus fee be based on net gains over the life of the portfolio or account, but only over selected measurement periods.

¹⁹ Record, p. 42

Relative versus Absolute

When choosing between an absolute and a relative basis for performance compensation, both the plan sponsor and the advisor must first determine whether there is relative benchmark against which the performance of the portfolio can be measured. Obviously, this will depend directly on the investment makeup of the portfolio as well as the investment objectives of the plan sponsor. Even in the absence of a directly comparable relative benchmark, it may be appropriate to consider a threshold of relative returns that must be achieved before the advisor is entitled to receive a share of the net gains in the account or portfolio.

Performance versus Penalty

Several other variables are critical in assessing the merit of any performance fees. For instance, if the advisor is entitled to a performance fee, should there also be a penalty? The answer depends on the size of the base fee in relation to the performance component and on whether there is a relevant benchmark to measure performance. If the base fee is relatively low, and the performance fee is based on the absolute performance of the portfolio, typically a penalty fee is deemed unnecessary.

Base Fee versus Performance Component

The relative magnitude of the base fee and the performance fee should be examined under a variety of performance scenarios and in light of both the presence or absence of a penalty component and the length of the measurement period. In fairness, the base fee should be sufficient enough to cover the resources necessary to service the account and the performance incentive should not be so large that the advisor may be tempted to take bigger bets than are appropriate for the account.

Who Wins ? Who Loses?

So who benefits the most from the trend towards performance based fees? As demonstrated in the table below, a “good” sponsor who has hired “good” advisors will lose, since payment under the traditional compensation structure would cost less. Conversely, the “good” advisors win since they will receive higher fee income. Similarly, the “average” sponsor with “average” advisors wins at the expense of the advisors. Finally, “poor” sponsors with “poor” advisors also win. “Poor” advisors presumably would go out of business.²⁰

Exhibit VIII

		Advisor Performance		
		Good	Average	Poor
Sponsor		Loses	Wins	Wins
Advisor		Wins	Loses	?

Among the advisors, conceivably only the “good” will benefit under the trend towards performance fees. Perhaps the advisors are promoting the concept of performance fees on the chance that they will all be considered “good”? Regardless, the “poor” advisors clearly will fail faster under performance fees than with traditional asset-based fees. It would appear that the sponsors have more to gain and less to lose than the advisors from this trend towards performance based fees.

²⁰ Grinold, p.36

Conclusion

If performance based fees are ill-conceived, not properly analyzed and not properly understood, they can be much worse than the traditional asset-based fee structure. Although any fee structure may provide certain incentives, the principal incentive should be to provide superior performance in the context of the plan's investment objectives. Under certain particular facts and circumstances, plan sponsors may determine that a performance fee is the most appropriate fee given the plan's investment objectives. While in other cases, the plan sponsor may determine that a fee without performance features is more appropriate. Regardless of the fee structure selected, plan sponsors and advisors alike must be able to conclude that the arrangement is fair and reasonable and be confident that they both understand how it will work.

Chapter Six

Conclusion

For years, many have joked that the second oldest law of economics, behind the law of supply and demand, is that for every positive there is a negative. This “law” certainly applies to the trend towards performance based fees. Performance based fees have several positives and negatives relative to the traditional compensation fee structure. Among the positives are the following:

- *Choice*: There is a much wider range of possible fee structures that can be tailored to an individual plan sponsors investment needs.
- *Alignment of interests*: The advisor’s interests are closely aligned with those of the plan sponsor. This fee structure rewards the advisor for acting in the best interests of the sponsor.
- *Reward*: Good advisors will prosper. To the extent that performance fees reward advisors who perform well, they produce a coincidence of goals.
- *Fairness*: To the extent that the performance objectives are reasonable, attainable and that the structure rewards the advisor relative to performance, they are fairer to both the plan sponsor and the advisor.
- *Overall Fees*: Under realistic assumptions, the aggregate fees paid by the sponsors to advisory firms will be lower and more representative of value-added which is a positive for plan sponsors.

As for the negatives:

- *Barriers to entry*: Performance based fees will certainly increase the barriers to advisory firms that are not well capitalized.
- *Complications*: Performance based fee structures are more complicated. A more complicated environment increases the likelihood of gaming and miscommunication between the advisor and the plan sponsor.
- *Current Incentives*: Current incentives for superior advisor performance are already quite strong.

- *Monitoring:* There is a need for continual monitoring and review of each advisor's performance. This makes for additional costs and complexities.
- *Overall Fees:* Under realistic assumptions, traditional asset-based fee structures provide for higher aggregate fees. A positive for advisors.

Many industry experts agree that the intensive management activities required of a real estate investment advisor may make performance compensation more appropriate for management of real estate than for management of other asset classes. Indeed, as the PREA survey demonstrated, the very nature of real estate investment management and the substantial fees associated with management of real estate assets certainly have led most plan fiduciaries to this conclusion.

However, in light of the uncertain state of the law concerning performance fees, many plan fiduciaries and advisory firms continue to struggle with the intricacies of ERISA. These legal concerns combined with the trend towards rewarding absolute performance due to the lack of accurate performance indices against which to measure performance, certainly require the fiduciary authorizing the performance fee to engage in more intensive scrutiny in the case of its real estate advisor than in the case of asset managers of other asset classes.

Despite the current enthusiasm for performance based fees, they are not without problems and improper incentives. However, most of these problems can be averted by plan sponsors closely monitoring the activities of the advisors and carefully developing, in conjunction with the advisors, a fee structure that creates the appropriate incentives and closely aligns both parties' interests. However, given that the industry is far from having developed any industry standard concerning the performance of advisor portfolios, time will be the only indicator as to whether performance based fees will be the standard for the next century or merely a long forgotten knee jerk reaction to the low real estate returns of the last decade.

Appendix I

I. Current Management Fee Structure - Portfolio #1

For each of the five largest portfolios under management (both separate accounts and commingled funds) please check the appropriate boxes and briefly describe (where applicable) your current fee structure for the following areas:

Description of Account/Fund

Date of formation: _____

Value of entire portfolio _____

Equity: _____

Debt: _____

- ☐ Private
- ☐ Public
- ☐ Separate Account
- ☐ Commingled Fund

Asset Management Fee

What is the asset management fee structure for this portfolio?

- ☐ Performance based fee

What is basis for fee:

☐ _____ % over _____ % hurdle rate of return

☐ _____ % over benchmark

☐ NCREIF

☐ Inflation

☐ _____ % of revenue

☐ NOI

☐ Cash Flow

☐ Other - explain: _____

- ☐ Fixed percentage of assets under management

What is basis for valuation of assets:

☐ Appraisal - what percentage? _____

☐ Cost - what percentage? _____

☐ Other - explain: _____

Acquisition Fee

Do you receive an acquisition fee?

☐ No

☐ Yes - What is the acquisition fee?

☐ Percentage of equity - what % _____

☐ Percentage of total cost - what % _____

☐ Flat fee - what is fee? _____

☐ Function of deal size - explain: _____

☐ Other -explain: _____

Financing Fee

Do you receive a financing fee?

☐ No

☐ Yes - what is the fee? _____

Disposition Fee

Do you receive a disposition fee?

☐ No

☐ Yes - what is basis for fee?

☐ Flat fee - what is fee? _____

☐ Tied to performance

What is the benchmark for performance?

☐ _____ % over NCREIF

☐ _____ % over _____ % IRR
hurdle rate of return

☐ Other - explain: _____

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